With interest rates set to rise, advisers keeping watch on bond investments

By Lynn Asinof | GLOBE CORRESPONDENT APRIL 05, 2015

It's a good news-bad news scenario. If interest rates rise, as many now predict, investors will find it easier to earn more on fixed-income investments such as bonds. The bad news is that rising rates — which push bond prices down — could put a big dent in the value of current holdings.

"The hardest thing to invest in right now is the bond portion of people's portfolios," said Dana Levit, a fee-only financial planner with Paragon Financial Advisors in Newton.

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Paragon Financial's Dana Levit recommends a mix of short-term bond funds and individual municipal bonds.

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Investors, she says, have come to think of bonds as sleep-tight money, providing a cushion to the volatility of the stock market. Now, with interest rates poised to move upwards, investors are trying to figure out how to maintain the protection their bond portfolio is supposed to provide.

It's not an easy job. For the past several years, pundits have said interest rates — still hovering at historic lows — have no place to go but up. "But the pundits have been wrong," said Gerard Silberman, a senior vice president and financial adviser who specializes in municipal bonds at Morgan Stanley Wealth Management in Boston.

The question today isn't just whether interest rates will rise, but also when they will rise, how fast they'll rise, and how high they will go. The Federal Reserve, which has held its benchmark interest rate near zero since 2008, recently signaled it would start boosting rates as soon as June.

The nightmare scenario, of course, would be rates spiking, leaving investors with sudden, big losses in their bond portfolios. But that's not likely to happen, said Beth Gamel, a managing director with Argent Wealth Management in Waltham.

Her firm recently did a review of interest rate increases over the past 60 years. It showed rates rising gradually and over time. According to the data, Fed tightening, which has taken place 10 times since 1954, lasted from 15 to 64 months, with rates during those periods rising an average of 5.3 percentage points. Even the early 1980s — during which the 30-year Treasury bond peaked at about 15.2 percent — were part of a rise that began in 1977 and lasted four years. The rate today on the 30-year is about 2.5 percent.

So what are investors to do?

They can start by making sure they have enough cash available to cover short-term expenses. "Next year's tax bill, next year's tuition bill. That's the starting point," says Christine Benz, director of personal finance at Morningstar Inc., a Chicago-based provider of independent investment research. Investors don't want to have to sell bonds in a down market to come up with cash, she said.

Next, they can make sure they're diversified. High-yield bonds, for example, pay higher yields because they are riskier, but that also makes them more vulnerable to big losses than blue chip corporate or government bonds. And you never know what is going to

happen. Last year, tax-exempt municipal bonds, usually steady but unspectacular performers, experienced some of the bond markets' biggest gains in value. Those who held munis in their portfolio benefited.

"So don't put all your eggs in one basket," Morgan Stanley's Silberman said.

Also, avoid the long end of the bond market. Shorter maturities will sustain less damage in a rising rate environment — they turn over faster, allowing people to capture the new higher rates more quickly as their investments mature.

Moreover, there's currently little incentive for investors to extend much beyond 10-year maturities. Investors earn less than 2 percent on a 10-year Treasury; extending the maturity to 20 years would add only about a third of a percentage point to the yield.

Finally, take time to consider the best way to buy bonds.

Some money managers like to use individual bonds, which typically offer buy-and-hold investors protection from bond market fluctuations. That's because individual bonds continue to pay their interest until they mature, at which point investors get their principal back.

But buying individual bonds can be tricky because bond quality, maturity, market sector, taxability, and issuer can affect the investment's value. "It is not easy to navigate hundreds of billions of bonds in the market," said Brad Currie, managing director at Moors & Cabot, a Boston broker-dealer specializing in municipal bonds.

Then, too, there's the question of how much you plan to invest. Advisers say investors need a bond portfolio of at least $100,000 to even begin to achieve the required diversification. That's why many advisers use bond funds. "Unless people are buying Treasury bonds, I am firmly in the camp that funds are the better options," Morningstar's Benz says.

Bond funds are well suited for those with smaller amounts to invest, allowing them to spread their investments across a wide swath of the market.

Bond funds do charge management fees, which vary. Moreover, rising interest rates would probably result in a loss in the value of bond fund holdings, said Jill Boynton, a fee-only financial adviser at Cornerstone Financial Planning in Newington, N.H.

“They will recover, but it may take a while,” she said. Over time, she said, the funds’ ability to buy new higher-rate securities will increase income flowing into the fund and offset the losses in principal.

You can also take a hybrid approach. Paragon Financial’s Levit is putting her clients into a mix of short-term bond funds and individual municipal bonds, using a bond specialist to create a diversified portfolio of these tax-exempt bonds.

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