Bond fund investors of all stripes have been dumping their holdings. Some are heading to cash, some to stocks. America’s thirty year love affair with bonds is clearly on the rocks.

The catalyst? Stern warnings from our central bank that it plans to “taper” its purchase of $85 billion of bonds each month. Of course, what really got investors’ attention was the disastrous returns on their fixed income funds. Funds linked to the broad based Barclay’s Aggregate index have slid 3.3% since the beginning of May.

But, that’s mild compared to the shellacking that other fixed income categories have seen since then. Municipal bonds are down 7%, long dated Treasuries 12.15, and emerging market debt 7.5%.

Meanwhile, it’s party hearty in the stock world, motivating some fixed income investors to rotate into equities. Both the Dow and S&P continue to set all-time highs. The S&P 500 has returned over 6% since the start of May, a head turning 20% year to date.

Bondholders now are in an awkward position. Amid the dire predictions from the Federal Reserve, the erosion in bond prices and spike in yields, and a raging equity bull market, is this the wake up call to flee a sinking fixed income ship?

**Bottom Line**

Investors should not be abandoning fixed income if it’s a part of a carefully crafted allocation between investments and asset classes. Indeed, many balanced portfolios are now overweighted in stocks and should be rebalancing in favor of fixed income.

Why add to the bond portion of your portfolio now? Predictions of much higher interest rates inflicting losses on bondholders may not be right, and in any event the much feared harm may already be reflected in prices, particularly in light of bond’s recent poor performance. More importantly, even if bonds don’t soar, you are reducing your exposure to an overheated stock market. Remember, during the 2008 crisis, high quality fixed income was one of just two asset classes that moved higher to help offset stocks’ 37% collapse that year.

However, for those overexposed to fixed income, who have been avoiding adopting a more diversified stance, the latest bond market selloff is indeed a siren sound to reduce exposure
and diversify into stocks and other asset classes. Your lowest risk portfolio is balanced and diversified.

**Consider Why You Own Bonds**

No one ever plunked money into bonds and bond funds as a quick road to riches. The correct reason to own bonds is to dampen the volatility of your equity and other risk asset holdings. They serve as a great hedge on a slowing economy, which could drive stocks into a correction or bear market. Bonds are the ticket to protect your portfolio if all the pundits who cheer lead “stocks for the long run” end up wrong, particularly for what you consider your long run to be.

Finally, fixed income produces income. However, given the liquidity of stocks in today’s low commission world, they are certainly not necessary to produce the monthly cash flow that many require.

**Interest Rates Move in Two Directions**

No one ever bought fixed income thinking interest rates would remain constant. That they’ve moved up since the beginning of May as well as down in recent years should not surprise any investor.

The big advantage bonds provide is that, absent default, no matter happens to the stock market or interest rates, you know exactly when you will receive back an amount certain. For those trying to plan for major purposes, that’s comforting. Unfortunately, bond funds cannot offer that same guarantee. However, their superior liquidity counsels maintaining a portion of your fixed income in them.

**How to Reduce the Risk of Higher Interest Rates**

If you are convinced that rates will move higher, shorten your maturities and durations. Maturity is when your principal is returned. Your duration measures the average of when all cash flows are paid to you; the larger the interest payments the shorter the duration relative to the maturity.

The ten year Treasury has an approximate duration of six. The duration informs you as to your loss (in this case 6%) should interest rates rise by 1% in a year.

So, you’re most insulated from the effects of rising interest rates by investing in short dated high yield bonds. Of course, high yield bond exposes you to credit risk.

Your riskiest bond, from an interest rate perspective, would be, say, a zero coupon 30 year Treasury. Because interest is completely deferred until maturity, your duration is equal to your maturity. A 1% increase in rates would court a 30% slide in value.
Best Opportunities Now

Opportunities abound amid those bonds that suffered price erosion disproportionate to their risks.

Closed end bond funds took the same hit that conventional mutual and exchange traded funds did. However, because closed end bond funds do not redeem their shares, during the recent near panic conditions to exit these funds, their share prices slipped to marked discounts to the value of their holdings, or net asset value.

Many close end bond fund investments are definitely bargains now, because you can measure the amount of the discount from what prevailed as recently as April. Insiders are taking note; recent SEC filings show thousands of shares being scooped up at Western Asset Mortgage Defined Opportunity Fund (DMO) and Western Asset Income Fund (PAI). Profit if the discount closes up, interest rates decline, or you simply collect the greater yields due partly to the higher interest rate environment and partly due to buying into the fund at a discount.

One closed end fund we favor now is MFS InterMarket Income Trust (CMK). This fund pays out 5% annually from a well-diversified, fairly short dated portfolio. It’s a bargain because you can buy shares at an 11% discount from the fund’s net asset value, significantly wider than the 3% discount it has traded at in the last year. No matter where interest rates go, you have the advantage of being able to buy the shares some 12% less than last year’s.

Muni Bonds: Higher Yields, Still Tax Free

Municipal bonds offer good opportunities, too, as the recent sell off boosted yields significantly. In many cases taxable investors would find it impossible to net after tax what munis of similar credit quality yield.

Adding further pressure on munis during the recent fixed income sell off was that most municipals are held by individuals. Individual investors can generally most benefit from the tax exempt interest, plus municipals are generally less liquid, making them a less attractive asset class for institutional investors. As it was individuals as opposed to institutions who were most inclined to dump fixed income rashly after Mr. Bernanke’s jawboning, we believe there’s an overreaction in this asset class, thus providing the opportunity.

In addition, the Detroit bankruptcy has cast a pall. We don’t believe Detroit is typical of most municipalities. To the extent other investors choose to dump their munis simply due to Detroit, we believe there’s an opportunity.

How to play it? Stay diversified, and overweight your home state’s bonds so as also to sidestep state income taxes.
For the more aggressive, we also favor insured bonds from some of the problem jurisdictions. For example, some of the insured Detroit bonds are now yielding 5% despite the fact that you’ve got a highly rated insurance company guaranteeing all the payments. Some Detroit school bonds are backed by the State of Michigan, sport an attractive 5.25% coupon, are non-callable, and mature in 2026. Some California bonds are also highly attractive when you consider their insured status.

A Good Tip: TIPs

Finally, Treasury Inflation-Protected Securities (TIPs) are quite attractive here. Interest payments are minimal, since their attraction is that their principal value escalates with inflation. With the second quarter sell off, any inflation that exceeds say 2.2% will make these more profitable than conventional Treasuries. These are particularly attractive for portfolios light in equities and thus in greater need of hedges against higher prices.