

Fixed-Income Pros Fear 'Bond Fund Bubble'

Seeking safety, inexperienced investors have poured record volumes of assets into bond funds. That's risky—especially if interest rates rise

By [Ben Steverman](#)

Good news for the economy could be very bad news for bond investors this year.

It may come as a shock to the unprecedented number of retail investors who—fleeing the stock market and seeking stability—have poured their savings into fixed income over the past year, but rising interest rates can hurt the value of bond investments. With the U.S. Federal Reserve holding its federal funds rate near zero, short-term rates have nowhere to go but up. The Fed said in a statement on Apr. 28 that it expects "exceptionally low levels of the federal funds rate for an extended period," but an improving economy could cause the Fed to change its stance. Economists' predictions vary, but typical is Jefferies Fixed Income's prediction that the Fed will begin raising rates in the first quarter of 2011.

Although the economic environment still feels bleak to many Americans, a rebound could be swift, especially if stimulus from the Fed and the federal government proves successful. [Data released on Apr. 30](#) showed that U.S. gross domestic product grew at an annual rate of 3.2 percent in the first quarter of 2010. "Once those sparks catch fire, it's going to be a quick turn in the economy," predicts Lorenzo Newsome Jr., chief investment officer at Xavier Capital Management in Largo, Md. That will push up interest rates by the end of 2010 and "cause the value of investment-grade bonds to fall," he says.

Feeling the impact could be millions of new, inexperienced, fixed-income investors. According to [TrimTabs Investment Research](#), investors poured \$467.2 billion into bond mutual funds in 2009 and a further \$115.8 billion so far this year. By contrast, an average of \$43 billion flowed annually into bond funds from 2003 to 2008.

"It's a bond fund bubble," says Marilyn Cohen, chief executive of Envision Capital Management in Los Angeles and author of the book *Bonds Now!: Making Money in the New Fixed Income Landscape*. Most of these new fund owners are "unsophisticated investors" who are unaware how much rising rates can hurt bonds, she says. (Because institutions and wealthy investors tend to buy securities directly, mutual fund customers tend to be retail investors.) "If we get a big spike in rates, there will be a mass panic," Cohen says.

OVERLOOKING RISKS IN EQUITIES, BONDS

Given the events of the past three years, individual investors' preference for bonds is understandable. Cash in money markets currently offers miniscule returns, while the U.S. stock market's perils became all too clear in 2008 and early 2009. According to TrimTabs, \$11.9 billion has been pulled from U.S. equity funds in the last 12 months, even as the S&P 500, the broad stock market index, rose 76 percent since Mar. 9, 2009.

"Before 2008, people were not really recognizing the risk in equity markets," says Eric Meermann, financial planner and portfolio manager at Palisades Hudson Financial Group in Scarsdale, N.Y.

Now, many may not recognize the risk in bond markets. "We foresee a rising interest rate environment, and investors need to be aware of the risks associated with that," says Ron Florance, director of asset allocation and strategy at Wells Fargo Private Bank ([WFC](#)).

Bonds vary widely but there are two main types of risk embedded in all fixed income products: credit risk and interest rate risk. Credit risk is the risk that a bond issuer will not be able to pay, a possibility with which investors in Greece's government debt are currently contending. Interest rate risk is the possibility that—because of Federal Reserve action, a stronger economy, or fears of inflation—rates could rise. A higher yield on a bond makes it more attractive to new investors but hurts its market value for current bondholders.

There remain glimmers of hope for bond investors. "Rising rates are not a foregone conclusion," says J. Michael Martin, president of financial planning firm Financial Advantage in Columbia, Md. A weak economy could keep the Fed from raising interest rates. Even if the Fed raises short-term rates, long-term rates could remain low if the threat of inflation seems limited.

LONG-TERM BONDS FACE GREATEST RISK

If you own an individual bond, its market value may not be relevant to you. You can simply hold it until it matures, when—assuming the issuer remains creditworthy—you will be repaid in full. However, Martin notes, by holding onto the bond for so long, you may miss out on other investment opportunities. In a higher-interest-rate environment, for instance, other bonds may offer more income.

Most retail investors can't afford to own individual bonds, and even wealthier investors often prefer the lower costs and diversification of bond funds. Higher interest rates are likely to hurt the net value of these funds, particularly funds that hold long-term bonds, says Bill Larkin, fixed-income portfolio manager at [Cabot Money Management](#) in Salem, Mass. "Long-term [bonds] can really take a hit if the rate environment changes rapidly," Larkin says. Medium-term bond funds have greater flexibility to make up for market losses by moving into higher-yielding bonds, he says.

While Larkin suggests investors move from long-term to medium-term bond funds, he also suggests diversifying with an array of exchange-traded funds that includes exposure to gold, commodities, bonds, and stocks.

Cohen suggests that investors also "take some profits off the table" and move out of longer-term bonds. She suggests safer, short-term bonds. For investors seeking a relatively stable alternative to bonds, Prudential Financial ([PRU](#)) market strategist Quincy Krosby recommends high-quality, large-cap stocks.

Although many economists predict a strong economic recovery, the opinion is not unanimous. Economic events might wreak unexpected effects on the bond market, which Larkin calls "impossible to predict." The warning from investing pros to bond fund investors is that the bond market could be entering a period of higher-than-normal risk, and investors need to be aware of those dangers.

The next three years could be interesting times for bonds, Florance says. "This is not time to get lazy with your fixed-income portfolio," he says.

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