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**BARRON'S PENTA**

## Shielding Your Bonds From Rising Rates

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**THE LONG BULL MARKET IN** bonds—spanning everything from Treasuries to high-grade corporate debt to junk bonds—has mostly been about preserving wealth, even if it means accepting relatively low yields.

Now that global central banks are printing money with the stated purpose of stoking inflationary forces, suddenly there's a kink in the strategy. How do you protect your bonds from inflation and the resulting higher interest rates? Even a one-percentage-point climb in rates from today's ultra-low levels could take a big bite out of the value of previously issued bonds, as their returns start to look paltry.

Wall Street, as always, is happy to meet any demand for hedges against rising interest rates—often with complicated and expensive instruments. As a rule, brokers' firms charge the most for instruments explicitly designed to solve a particular problem. And for direct protection against rising rates, the costs can easily outweigh the benefits.



For instance, a large firm today might offer protection against a dramatic run-up in the yields of 10-year Treasury bonds over five years—to perhaps 4.25% from 3.01% today; the fee might be \$100,000 per \$10 million in bonds owned. That might seem, at first, like a relatively small price for enjoying much higher yields later on. But in fact, that hedge doesn't really start to cover the cost until yields surpass 5%. For example, when yields hit 4%, you've lost many times more than the \$100,000 fee on the bonds. And if yields do reach 5%, your core bond portfolio would already have sustained significant losses. This kind of position is better viewed as catastrophe insurance rather than true loss protection.

Sam Katzman, chief investment officer at Constellation Wealth Advisors, which serves wealthy families, says, "When you look at hedging fixed-income portfolios, a lot of people think about 'tail risk' -- that is, a sudden and large surge in rates. "But tail-risk options have been expensive since the financial crisis."

Instead of an outright, over-the-counter hedging instrument, "we'd say it's better to position a portfolio for what you think will happen," Katzman says. That is, if you think rates will trend higher

mainly in long-term bonds, where the Fed isn't actively bidding, then it makes sense to overweight short-term maturities.

Katzman recommends a "barbell" strategy" that is divided between very short-term bonds that will mature soon and allow cash to be reinvested at higher or at least equivalent yields, and longer-term paper that delivers higher levels of income today.

Specifically, he favors about 75% of a bond allocation in one-year to five-year debt, and the rest in more distant maturities.

Of course, Treasury Inflation-Protected Securities, or TIPS, offer an explicit hedge against official, government-measured inflation, by adding to the base coupon a payment that accounts for any increase in the consumer-price index. Yet TIPS appear fully valued; recently, they've been priced to deliver a negative initial interest rate, in recognition of higher inflation expectations.

You may also be able to protect yourself with high-yield, or junk, bonds. Tony Roth, chief investment officer for the wealth-management division of UBS, cautions that "rising rates and inflation are not synonymous. I could foresee an environment in which market rates at the long end move up significantly without inflation" rising much. "I'd expect the yield curve to significantly steepen as the Fed artificially holds down the short end and long rates go up as [the U.S.] might not be able to import enough capital."

Roth points out that when market rates begin to rise, high-yield corporate bonds historically perform quite well, with the yield premiums over Treasuries, or spread, falling appreciably. This is because the first leg higher in Treasury yields usually corresponds with the kind of pickup in economic activity that benefits the companies that issue high-yield bonds.

"We still think there is room for more spread compression," Roth says.

Some other options: bank-loan mutual funds, which tend to hold floating-rate loans, as well as the debt of foreign governments, which can offer a yield premium and benefit from any further weakening of the U.S. dollar.

Roth points to the debt of Australia. Not only has the Australian central bank begun cinching official rates higher, but the Aussie dollar is among the clearest beneficiaries of a commodities bull market that would no doubt gain strength in an inflationary scenario.

Most discussions of hedging against higher interest rates make their way to the handful of exchange-traded funds designed specifically to profit from weakening bond prices. Among the most popular of these is the [ProShares UltraShort 20+ Year Treasury](#) fund (ticker: TBT), a leveraged play on rising long-term government borrowing rates.

Funds such as this perform exactly as designed—but that's one reason they aren't suitable as a buy-and-hold hedge for a bond portfolio. Specifically, the TBT and others like it deliver twice the inverse of the one-day percentage change in long-term Treasury prices. For example, if the Barclays Capital 20+ U.S. Treasury index falls 1% in a day, the TBT would gain 2% in value -- and vice versa. This means that over time, the funds' investment results will diverge from the longer-term value of Treasuries, as the sequence of one-day moves up and down throw off the performance of the fund.

Alas, in investing as in other areas of life, there is no free lunch. But with a bit of study it's possible to get a reasonably well-priced defense against the likelihood that the bull market in bonds might be nearing an end.

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