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BUSINESS

Safeguard your portfolio with these bond strategies for tough times



**David
Twibell**

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With inflation still higher than the Federal Reserve would like, another round of interest hikes is a real possibility this year. That could be bad news for bond investors, since most bonds lose value when interest rates rise. Here are four ways to help safeguard your portfolio if the Fed does decide to raise short-term interest rates again.

Treasury Inflation Protected Securities

First issued by the U.S. Treasury in 1997, TIPS are bonds with a portion of their value pegged to the inflation rate. Consequently, if inflation rises so will the value of your TIPS. Since interest rates rarely move higher unless accompanied by rising inflation, TIPS can be a good hedge against higher rates.

TIPS aren't for everyone, though. First, they generally yield less than traditional Treasuries. For example, the 10-year Treasury note recently yielded 4.75 percent, while the corresponding 10-year TIPS yielded just 2 percent. And second, because the principal of TIPS increases with inflation, not the coupon payments, you do not get any benefit from the inflation component of these bonds until they mature (although you are required to pay federal taxes on this "phantom" inflation-related gain annually).

Floating rate loan funds

Floating rate loan funds are mutual funds that invest in adjustable-rate commercial loans. These are a bit like adjustable-rate mortgages, but the loans are issued to large corporations in need of short-term financing. They are unique in that yields on these loans adjust periodically to mirror changes in market interest rate.

This helps bond investors in two ways: (1) it provides them more income as rates rise, and (2) it keeps the principal value of these loans stable, so they don't suffer the same deterioration that afflicts most bond investments when rates increase.

Investors need to be careful, though. Most floating rate loans are made to below-investment-grade companies. While there are provisions in these loans to help ease the pain in case of a default, investors should still look for funds that have a broadly diversified portfolio and a good track record for avoiding troubled companies.

Short-term bonds

Another option for bond investors is to shift their holdings from intermediate and long-term bonds into short-term bonds (those with average maturities between one and three years). While prices of short-term bond funds do fall when interest rates rise, they do not fall as fast or as far as

their longer-term cousins. And historically, the decline in value of these short-term bond funds is more than offset by their yields, which gradually increase as rates climb.

Bond ladders

“Laddering” your bond portfolio simply means buying individual bonds with staggered maturities and holding them until they mature. Since you are holding these bonds for their full duration, you will be able to redeem them for face value regardless of their current market value.

This strategy allows you to not only avoid the ravages of higher rates, it also allows you to use these higher rates to your advantage by reinvesting the proceeds from your maturing bonds in newly-issued bonds with higher coupon rates. Diversifying your bond portfolio among two-year, three-year, and five-year Treasuries is a good start to a laddering strategy. As rates rise, you can then broaden the ladder to include longer maturity bonds.

David A. Twibell, J.D., is president of Private Wealth Management for Colorado Capital Bank, where he directs the bank’s portfolio management and wealth advisory practice. He can be reached at 303-814-5545 or dtwibell@coloradocapitalbank.com.