

Investing in Bonds Will Be Much Trickier in 2010

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Bond managers will tell you that they always actively manage their portfolios, but they are really going to have to earn their money this year. As the stock market imploded last year, many investors fled equities to find relative safety in fixed-income investments. In 2009, [a record \\$396.2 billion flowed into bond mutual funds](#). And this year, with stock markets more volatile than ever, bond funds continue to receive large inflows of cash.



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While bonds generated great returns, there are several concerns including growing fears of inflation and worries that the Federal Reserve will raise interest rates. The Fed on Thursday raised the discount rate it charges on loans to banks [to 0.75% from 0.5%](#), as *DailyFinance* reported. All this and the low yield on U.S. Treasuries make [investing](#) in bonds a far more risky proposition than it was a year ago.

As *DailyFinance* [warned earlier this month](#), those who indiscriminately dump money into bonds this year could be in for a bruising. In 2010, experts suggest it will take more aggressive than normal active management strategy to bring home the highest returns in the bond market.

Christian Hviid, director of asset allocation at Genworth Financial Asset Management, says investors will have to do more than they might normally do to deal with the economic environment expected in 2010. "Doing your homework by looking at the different segments within the fixed income market will be rewarded," says Hviid, "because not everything will move in the same manner."

Staying Short Is Paramount

"What you want to do in the bond market is stay on the short end of the curve," says John Lekas, president and CEO of Leader Capital Corp., which operates a short-term bond fund. "You want to buy high quality paper or treasuries on the short end of the curve. It's a little counter intuitive because right now it doesn't pay you a lot of current yield, but it's the only way to preserve principle."

At the end of January, Lekas said much of the short-term high quality securities in the Leader Short Term Bond ([LCCMX](#)) portfolio were generating a 3.5% yield. Preserving principle by locking in some guaranteed yield in this volatile environment is important for investors who've already taken a bath in the market meltdown that began in September 2008. Buying shorter-term securities provides flexibility to adjust portfolio holdings as market conditions change and better opportunities present themselves.

Also, as interest rates rise, longer duration bonds will be more negatively affected than shorter duration bonds. "Having a shorter duration profile is probably more prudent than having longer duration exposure mainly because of interest rate risk down the road," says Hviid. "The Treasury market is seeing a glut of supply given the fiscal deficits, so that adds an element of risk."

Floating Rate Notes Can Boost Returns

Using floating rate notes can also increase returns in a very volatile environment. "Floating rate exposure is another area worth looking at where you can immunize interest rate risk and benefit from rising interest rates if indeed that happens," says Hviid.

Lekas said about 45% of his funds' portfolio is in floating rate notes. He believes these securities give him the chance to pick up 6% to 7% returns on the investment, because the yield on the notes will adjust upward if interest rates rise. According to Morningstar, three of the Leader fund's top holdings are floating rate notes of Freeport-Mcmoran Copper & Gold ([FCX](#)), Fifth Third Bancorp ([FITB](#)) and Citigroup ([C](#)).

Since Treasuries and cash equivalents are offering little yield, Hviid says more risk-tolerant investors can turn to credit issues for higher yields.

Treasuries Are Out, Credit Is In?

"Underweighting Treasuries and seeking out short-term credit is an area where you can add value," he says. "There are opportunities to pick sectors and industries within the fixed income area that offer attractive relative yields."

To make the right decisions, a lot of time and due diligence must be put in. Hviid said buying the debt of specific companies with better-than-expected performance or buying the debt of certain countries could also prove fruitful.

"Emerging market debt still has some very compelling fundamental drivers associated with it, mainly the opportunity for spreads to come down as well as the benefit from underlying currency

appreciation coming out of those regions," he said.

Using a mixture of all these fixed income strategies can help investors garner positive returns during the volatile economic conditions expected this year.

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