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December 27, 2008

YOUR MONEY

Older Investors Should Examine the Risks in Bonds

By [TARA SIEGEL BERNARD](#)

For people in or near retirement, bonds were supposed to provide a sense of security.

But for some investors, they did precisely the opposite. Bonds of all stripes have taken sizable hits this year. The losses have not been as agonizing as the 40 percent decline in the stock market, of course, but any loss is particularly painful for people who count on these investments as a safety net.

“There haven’t been any safe places to hide, with the exception of Treasuries,” said Miriam Sjoblom, a mutual fund analyst at [Morningstar](#). “That has been a surprise to some investors.”

Several diversified bond funds have held their own — largely because they contained a healthy helping of Treasuries — which underscores the importance of diversification.

But for some older Americans, even that relative safety is not enough to allay their concerns. [Lehman Brothers](#) and [Washington Mutual](#) were top-rated bonds — until they were not. Even some money-market funds have run into trouble.

“Fixed income should be ultrasafe,” said Steve Podnos, a financial planner in Merritt Island, Fla. “The return of principal is more important than the return on principal.”

That is a popular mantra, especially now. Ultrasafe comes at a cost, however, and there are not many bulletproof investments that yield more than 2 or 3 percent, experts said. For the risk-averse, that might be plenty when you just do not know what might lurk around the corner.

And because conditions may worsen before they improve, older investors should check that their bond investments are indeed what they thought they were — and that they fit their tolerance for risk. “We are in a 2 to 3 percent world, and if they want to earn more than that

they need to proceed cautiously,” said Gary Cloud, a bond manager at Financial Counselors in Kansas City, Mo.

Several advisers and bond experts recommended that investors maintain higher cash reserves than they might in more normal times. Keeping two to three of years of living expenses in extremely safe investments, like a certificate of deposit or a money market account at a large financial institution, can provide some breathing room. That way, investors will not be forced to sell investments at an inopportune time.

Investors also need to remember that bond funds and individual bonds work a bit differently. With an individual bond, investors are guaranteed to receive their original investment back after it matures, as long as the company does not implode. With bond funds, there is no such guarantee because the value of the bonds inside will fluctuate with market conditions. That means the value of the investment will vary, too.

Of course, a sizable pile of money is needed to build a portfolio of individual bonds as opposed to simply purchasing a bond fund. Opinions vary widely — from \$50,000 to \$500,000 — on the amount needed to be properly diversified, though several experts agree it can be done with about \$100,000 to \$200,000. It is probably best to sit down with an adviser, preferably a fee-only adviser or one that charges by the hour, to go through the pros, cons and costs of each.

Some advisers have strong feelings about both instruments. Some refuse to use bond funds because they say they do not know what they own, though that problem can be addressed by using index funds, whose investments remain relatively static. Other advisers say they cannot attain the level of diversification with individual issues. Whatever you decide, knowing what you own and understanding the risks involved are what really matters. And if a bond investment promises high returns, a little mental bell should go off as a warning signal.

“We see a lot of retirees come in and they have a lot of their fixed-income investments in aggressive funds,” said Richard Rosso, a financial planner with [Charles Schwab](#) in Houston. “They have gotten seduced by the yield of the fund and didn’t look at how that yield was being derived.”

Instead, investors should anchor their portfolios with a fund, or combination of funds, that hold wide swaths of high-quality government-backed, corporate and mortgage-backed bonds — with short- to intermediate-term maturities, experts said. (Shorter-term securities are less sensitive to changes in interest rates; when rates rise, bond prices fall). Low

expenses are extremely important because bond funds do not yield much to begin with. The Vanguard Total Bond Market Index fund fits that bill. It is up nearly 5 percent this year and charges a rock-bottom 0.07 percent of assets. Two actively managed options, Harbor Bond, managed by Bill Gross of Pimco, and FPA New Income — up 2.2 percent and 4.03 percent, respectively — are considered strong choices where capital preservation is a top priority, Ms. Sjoblom of Morningstar said. But, of course, they are more expensive.

Beyond a fund like the Vanguard Total Bond Market, advisers also recommend adding a dose of international bonds as well as Treasury inflation-protected securities, or TIPS, whose interest payments and underlying principal keep pace with inflation. [Deflation](#) fears are trumping inflation fears, at least for the moment, which has caused the price of TIPS to drop. But the government has printed a lot of new money and is expected to keep doing so, experts said.

“There is a possibility that inflation will heat up in the future, so why not add money as a hedge for future inflation?” said Mr. Rosso, especially now, when TIPS are attractively priced. He recommends limiting allocation of these to no more than 10 percent of bonds in a portfolio. They can be purchased directly (but keep those in a tax-deferred account) or in a fund or exchange-traded fund.

Meanwhile, high-quality municipal bonds — or funds — may be appropriate for certain investors. Because municipal bonds are generally tax-free, they tend to pay less in interest than their taxable counterparts, and normally make sense only for people in the highest tax brackets. But many top-rated municipal bonds are now yielding more than taxable bonds, which makes them attractive to a broader population, experts said. Despite budgetary troubles in places like New York and California, and the economic headwinds all municipalities face, advisers said sticking with the highest-quality short- and intermediate-term general obligation munis — or those backed by a municipality’s taxing power — are a reasonably safe bet.

“You can make the argument that anyone will do better owning that,” Mr. Podnos said. Long-term municipal bond funds have lost 10.5 percent for the year as of Wednesday, and shorter-term funds are up 0.5 percent, according to Morningstar. Short- and intermediate-term funds are not subject to as much volatility, he said, and will produce a combined tax-free yield of 3 to 4 percent, the equivalent of a 5 to 6 percent taxable yield.

For investors with even less tolerance for risk, advisers recommend the following:

C.D.’S Certificates of deposit, which pay a fixed interest rate but lock up money for three

months to five years, are guaranteed by the government for up to \$250,000 for each depositor at each bank. Guarantees are scheduled to drop to \$100,000 for each depositor at the end of next year. Callable C.D.'s may offer even higher yields, but remember that you are being paid more to take on extra risk: the bank can return your money before the C.D. matures, so you may have to reinvest at a potentially lower rate, Mr. Rosso said. And keep in mind that C.D.'s will penalize you, sometimes substantially, if you withdraw before maturity.

F.D.I.C. BONDS These government-backed bonds come with variable or fixed rates. They tend to pay more than Treasuries, with several batches of three-year bonds paying slightly more than 3 percent, though newer bonds have been paying slightly less. They have largely been issued by large financial institutions — like [JPMorgan](#) and [Wells Fargo](#) — participating in the government program that was created in October to help bolster the credit markets. The debt will be sold through next June and must mature in less than three years. Before you consider these, check whether there are comparable deals in C.D.'s.

GINNIE MAE Not to be confused with Fannie or Freddie, Ginnie is owned by the government and issues securities that are backed by federally guaranteed or insured mortgages. Translation: these are safe. Several advisers recommend Ginnie Mae funds — or the actual securities — as a higher-yielding alternative (about 2 percent) to money-market funds. But there is a big caveat: If interest rates move higher, the value of these securities will drop, Mr. Podnos said.

PRE-REFUNDED MUNIS Pre-refunded municipal bonds, along with escrowed-to-maturity municipals, are solid options because the payments the bond issuer must make to investors over the life of the bond are held in an escrow fund, usually comprising United States government securities. The yields tend to pay about two percentage points above Treasuries with a comparable maturity, said William Larkin, a fixed-income manager at Cabot Money Management. Just be sure the collateral is Treasuries. “It’s the safest of the safe,” added Marilyn Cohen, president of Envision Capital Management.

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