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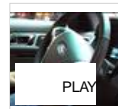
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FUND TRACK | JULY 14, 2011

Treasurys Loom Large in Index Bond Funds

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By IAN SALISBURY

NEW YORK—The U.S. government's heavy borrowing has significantly altered the complexion of the U.S. bond market and, with it, the holdings of mutual funds that hew to bond indexes.

At a time when some investors are questioning whether the long Treasury rally is overheated, this means fund holders face a difficult choice.

"We've had a lot of conversations with investors," says Matt Tucker, head of fixed income at iShares, the popular brand of index-tracking exchange-traded funds. "You have to make a choice whether to increase Treasurys or bet against Treasurys by buying something else."

Total U.S. Treasury debt has ballooned to more than \$13.6 trillion in September 2010 from about \$9 trillion in September 2007, according to the Treasury Department. In the same period, corporate and mortgage borrowings have been sluggish.

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That has altered the face of popular bond indexes, typically weighted by the market value of outstanding bonds. Treasury bonds now constitute almost 33% of the Barclays Capital U.S. Aggregate Bond Index, up from

less than 24% four years ago and the highest since the late 1990s.

Many bond-market experts, most notably Pimco's [Bill Gross](#), have warned that razor-thin yields—now at less than 3% on 10-year Treasurys—signal a coming bear market. Mr. Gross's Pimco Total Return, the world's largest bond fund, has less than 10% of its holdings in Treasurys and Treasury Inflation-Protected Securities, according to Morningstar Inc. Pimco didn't respond to requests for comment.

Not everyone shares Mr. Gross's concerns. Despite warnings about Treasury prices, which move inversely to yields, haven't responded.

Die-hard indexers tend to believe that, as with stocks, investors do better relying on the wisdom of the market. Their argument: the fact that investors have continued to pay top dollar for Treasurys despite measly yields reflects a market consensus that they are worth it.

"When you start to tweak a bond portfolio, it's tricky to be successful," says Joseph Davis, Vanguard Group's chief economist. "You have to anticipate events."

Still, experts say, investors who own index funds should at least be aware of the risks. And some are taking action. Merritt Island, Fla., financial adviser Steve Podnos worries Treasury bonds' extra-thin yields would provide too little cushion against losses if interest rates rise and prices fall. So last month he moved his clients from the Vanguard Short-Term Bond Index Fund to Vanguard Short-Term Investment-Grade Bond Fund after Treasurys climbed to nearly 60% of the broader-based fund. "We thought we had a nice mix of various kinds of short-term bonds," he says. "We had mostly Treasurys."

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