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GETTING GOING

By JONATHAN CLEMENTS



The Case for Bonds: With Rates Rising, It's Time to Move Out of Money Funds

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Cash may no longer be king.

Sticking with a money-market fund has been a smart strategy over the past year, as interest rates have climbed and as short-term yields have rivaled those on longer-term bonds. But with 10-year Treasury notes recently breaking above 5% for the first time in almost four years, this could be a good time for cash investors to take a little more risk.

Here's the case for tiptoeing into short- and intermediate-term bonds, while also snapping up inflation-indexed Treasuries.

• **Stepping out.** When interest rates climb, your first instinct should be to lengthen the average maturity of your bond portfolio, so you take advantage of the higher yields.

And interest rates, of course, have risen. At yesterday's market close, 10-year Treasury notes were paying a tad less than 5%, up from 4.4% at the end of 2005 and 3.1% in June 2003. Problem is, short-term interest rates have also climbed, pushing up the average yield on taxable money-market funds to 4.2%.


That would seem to give the edge to money funds, because they are pretty much risk-free. Bonds, meanwhile, could get hammered if interest rates continue to climb.

Remember, bond prices and interest rates move in opposite directions. That's lately been bad news for bond funds, many of which have posted modest losses this year as interest rates have spiked higher. Still, if you are hiding out in a money-market fund or a short-term certificate of deposit, you might want to step out on the yield curve.

Yield Plays		
To take advantage of today's higher rates, try these no-load funds.		
FUND	EXPENSES	YIELD
Fidelity Inflation-Protected	0.48%	2.45%*

Consider moving a chunk of your money into a low-cost, short-term bond fund that sticks with two- or three-year bonds, such as TIAA-CREF Short-Term Bond or Vanguard Short-Term Bond Index. You might move another chunk into an intermediate-term bond fund that owns bonds with five-to-10 years to maturity, like T. Rowe Price U.S. Bond Index or Vanguard Intermediate-Term Investment Grade.

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That way, you will pick up extra yield, possibly as much as a percentage point or more. It will also leave you in better shape, should short-term interest rates tumble.

True, there isn't much talk about that possibility right now. Instead, all the chatter is about how high the Federal Reserve will push short-term rates. But it is conceivable that today's hefty consumer debt, steep energy costs and higher interest rates will slow the economy, prompting an abrupt change in the Fed's policy -- and a sharp drop in short-term yields.

It's happened before. In 2001, the Fed orchestrated a collapse in short-term interest rates, causing the yield on taxable money-market funds to nose-dive that year to 1.6% from 5.9%.

By contrast, the yield on 10-year Treasurys barely budged during 2001, holding at just above 5%. But even if yields had fallen, bond investors would have had reason to cheer, because the decline in rates would have driven up bond prices.

"If you own six-month CDs, when you go to renew in six months, the rate could be much lower," warns Richard Schroeder, a financial planner in Amherst, N.Y. "But if you own a short-term bond fund, your yield would be protected for a while longer and you should get some capital gains."

• **Inflating profits.** When you buy your short- and intermediate-term bond funds, also consider putting in an order for some inflation-indexed Treasurys, formally known as Treasury Inflation-Protected Securities, or TIPS.

Inflation-indexed Treasury bonds are one of my favorite investments. They are a great way to diversify a stock portfolio, while also providing long-run protection against inflation.

The principal value of inflation-indexed Treasurys is stepped up along with the consumer-price index. You also earn a small amount of additional interest. This "real" yield reflects your gain above inflation -- and right now the rate is pretty attractive.

For instance, if you buy 10-year inflation-indexed Treasurys today, you can lock in a yield above inflation of just under 2.4 percentage points a year. That's some 2.6 percentage points less than the 5% yield on conventional 10-year Treasury notes.

In other words, if annual inflation turns out to be higher than 2.6% over the next 10 years, inflation-indexed Treasurys will outperform conventional Treasury notes. That strikes me as a distinct possibility.

But even without a pickup in inflation, the yield on inflation bonds looks pretty appealing. The average historical, after-inflation return on conventional intermediate and longer-term bonds is roughly 2.3%, notes investment adviser Larry Swedroe, co-author of "The Only Guide to a Winning Bond Strategy You'll Ever Need."

With inflation-indexed Treasurys, "you should be willing to accept a lower return, because you're getting insurance against unexpected inflation," he argues. Indeed, when 10-year TIPS hit 2.15% late last year, Mr. Swedroe started buying individual inflation-indexed Treasury bonds, and he has continued to buy as rates have climbed.

If you prefer mutual funds, check out offerings like Fidelity Inflation-Protected Bond or Vanguard Inflation-Protected Securities. One warning: Like other taxable bonds, inflation-indexed Treasurys

can generate big tax bills. To postpone those bills, hold your inflation-indexed bonds or funds inside a tax-sheltered retirement account.

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