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Worried About a Bear Market In Bonds? Here's What You Can Do.

ALTERNATIVE INVESTING | GREGORY ZUCKERMAN

Q: Are there ways to protect a portfolio from a bear market in bonds?

A: There's growing concern in bond land. The stock market is firming, some investors are shifting cash from bonds to equities, and interest rates, still near all-time lows, likely will move higher over the next few years if the economy keeps improving, analysts say. That would push bond prices, which move in the opposite direction of rates, lower.

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While advisers say shorting individual bonds can be dangerous and difficult for individual investors, there are other things they can do to prepare for a bear market.

A first step is to trim bonds with longer maturities. "Because bond prices are sensitive to interest rates, short -term bonds will not be as badly affected" by rising rates, says Scott Miller Jr., a managing partner of Blue Bell Private Wealth Management LLC in Blue Bell, Pa.

Some advisers say exposure to junk bonds should be reduced. Don't sell them all, though. High-yield bonds usually are viewed as quasi-stocks. As such, they will be helped if the stock market continues to rebound. Instead, some analysts recommend the Pimco 0-5 Year High Yield Corporate Bond Index (HYS), an exchange-traded fund that tracks the performance of short-term junk bonds and sports a yield of over 5%.

Jeff Fishman, president of JSF Financial LLC, a Los Angeles-based financial-advisory firm, says one way to profit from a drop in Treasurys is to buy an ETF that rises in value as Treasurys fall in price, such as the ProShares Short 20+ Year Treasury (TBF), which buys derivative investments in the hope of achieving a return that's the inverse of the daily results of Barclays's benchmark index of 20 -year Treasurys. More adventurous investors may choose to buy the ProShares UltraShort 20+Year Treasury (TBT), which aims for daily returns that are twice the inverse of the Barclays Treasurys index.

Yigal Newman, JSF's chief investment officer, cautions that these ETFs are much better at tracking markets over shorter periods than longer periods. That makes these ETF trades ideal for investors looking to protect their portfolios over short periods, but more questionable as long-term investments.

Mr. Newman says investors may wish to purchase "put" contracts on ETFs tracking the Treasury market, such as the iShares Barclays 20+ Year Treasury Bond Fund (TLT). These put contracts could rise in value when the ETF falls.

Mr. Miller is a fan of "kicker" bonds, also known as "cushion" bonds. These are long-term bonds with high coupons that may be called, or redeemed, by the issuer in the near term. Because these bonds may be called, they tend to trade at a yield that's higher than comparable bonds. And if interest rates rise and the bonds aren't called, their yield increases, or kicks up.

"In a rising rate environment, kicker bonds should provide a cushion" compared with other bonds, Mr. Miller says.

Mr. Fishman urges investors to make sure their portfolios are diversified across various fixed-income products to reduce risk. He says emerging-market bonds and funds that invest in senior bank loans, which have floating rates that reprice every 90 days, typically hold up better than other bonds in bear markets.

Shorter-term corporate bonds of top-rated issuers also should hold up in a bond-market tumble, says Richard Platte Jr., portfolio manager of the Ave Maria Bond Fund (AVEFX).

Step-up bonds, which pay an initial rate or coupon and "step up," or readjust to a higher coupon rate until maturity, also are a potential way to protect a portfolio in a rising-rate environment, advisers say, as are floating-rate preferred stocks, which also see their yields rise.

John Lekas, who manages the Leader Short Term Bond Fund (LCCMX) and Leader Total Return Fund (LCTRX), recommends floating-rate notes tied to 10-year Treasury notes. "The coupon will move up and they will increase in value as interest rates rise," he says.

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