THE MONEY MARATHON: HOW TO INVEST FOR THE PENDING BOND BUBBLE-PART 2. MARCH 2011

Last month, my article discussed the potential for a bond bubble. In other words, after 20 years of lower and lower interest rates, rates may go up in the next year or so and when they do owners of long term bonds may be in for a rude awakening as their bonds drop in price. As an example, I mentioned that a 3% increase in rates would drop the value of a 30 year government bond by 36%. In that case, a $100,000 investment could drop in value to $64,000. Pretty scary for what is normally considered a safe investment. So what should an investor do? Here are some options.

STAY WITH SHORT MATURITY, TOTALLY SAFE INVESTMENTS AND WAIT FOR INTEREST RATES TO MOVE HIGHER.

Short maturity treasury bills and bank insured certificates of deposit are riskless investments, but with today's low rates, certificates of deposit (CDs) in the six month to one year range will probably only pay in a range of .75% to 1.30%. It is wise to have some investments totally safe in case there is a disaster or crash, and liquid enough, that they can be used to take advantage of investment opportunities. C Ds can do this, but a 1% or less yield will not earn much of a return for a large part of your investments. If this pool of funds is too large, a person's return could be lowered dramatically.

BUY SAFE INVESTMENTS WITH LONGER MATURITIES.

The difficulty with this strategy is that the longer the investment, the more risk of price drop when rates increase. As an example, 5, 10, 20 and 30 year government bonds might earn respectively 2.5%, 3.5%, 4.1% and 5%. These yields are tempting, especially the 4% and up yields, but again, subject an investor to price risk if rates move up considerably. It should be noted that the yield curve is sloped, which means that long rates are much higher than short rates, a condition that is not always the case. If short rates go up, it is possible that the long rates may not go up as much as short rates or even not at all causing a flattening of the yield curve. In this case long bonds would not drop in value as much as if all rates increase. I would be careful investing in government bonds that are over 7 to 10 years in length. A lot can happen in more than 10 years.

CONSIDER INVESTMENTS WITH SOME DEGREE OF RISK BUT THAT HAVE HIGHER YIELDS.

Some examples of this are listed below: (I should note that each investor's situation, goals and objectives and risk tolerance are different, so be sure and visit with your professional investment advisor before making a decision to make sure these fit with your overall plan. It should also be noted that funds of products listed below are generally considered safer than an individual security because funds offer more diversification.)

*High quality stocks with high dividend yields. Many high quality stocks offer dividend yield of 3% or above, nearly equal to the yield on a 10 year government bond and some yield much more. AT&T, as an example pays a 6% plus dividend.

*Master Limited Partnerships. These are stocks that are structured in a way that allows them to pay out most of their earnings as dividends. Many pipelines are paying 6% plus yields and are increasing their dividend every year. Historically, these have been less risky than the average stock and pay higher returns. I think it is possible to consider these as somewhere between a stock and a bond in terms of risk. (There are some suitability issues that should be discussed with a financial professional or accountant before investing in these.)

*Investment grade corporate bonds with moderate maturities of 7 to 10 years or less. Bonds like Kraft Food or General Electric Capital pay approximately 1% over government bonds of that maturity. By taking a little credit risk, a person can increase his yield significantly.

*High Yield Bond Funds: Funds that buy lower quality bonds yield approximately 6% with maturities in the 5 year range. These bonds are not investment grade and have more credit risk. However for a portion of a portfolio, they can be a reasonable way to increase yield.

*Foreign Bond Funds or Bond Funds that buy foreign bonds can increase yield by 1% over similar maturity domestic bond funds. These bonds have risk of currency valuation changes too, but that could also help an investor if the dollar goes down in value.

*Municipal bonds: Many municipal bonds can have yields equal to treasuries. For investors in higher tax brackets, 35% and above, this can mean a significantly higher tax equivalent yield. In other words, a 10 year municipal bond yielding the same as a taxable 10 year treasury bond at 3.5% would in effect be earning a 5.38% tax equivalent yield for an investor in the 35% tax bracket. This means a taxable investment would have to yield 5.38% to be equal to the 3.5% after tax municipal yield. It should be noted that municipals can have more risk than they have had historically. Be careful to buy high quality municipal bond funds.

*Build America Bonds: These are taxable municipal bonds. Some of these bond funds in the 15 year maturity range yield nearly 5%.

*Treasury Inflation Protection bonds are also considered a good protection against higher rates. These are government guaranteed bonds that adjust annually to the rate of inflation. When inflation goes higher, the rate on this investment would also increase protecting an investor from inflation, which usually also leads to higher interest rates.

Most of these mentioned above can suffer in price when rates go up, but the downside may not be as dramatic as with long term government bonds and in the mean time a person can get a reasonable return while he waits. Keep in mind that diversification, (not putting all your eggs in one basket) is important and helps minimize risk. An overall portfolio should be designed to help reach investor goals without taking more risk than should be taken based on the investor's particular circumstances. Also, although I do not expect short term rates to go up this year, when they do start to go up they can go up fast, so it is important to be thinking ahead.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.

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