FIXED INCOME STRATEGIES

Short-term bond funds stage a comeback

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Beth Braverman, special to CNBC.com

KEY POINTS

- Rising interest rates and inflation can wreak havoc on bond returns but less so on short-term bond funds. Plus, the flattening yield curve means less incentive to look to the longer term.
- A recent analysis by Pimco found short-term strategies had an annualized volatility of less than 1 percent over a 10-year period.
- Shifting some cash allocation to short-term bond funds might make sense for investors with a shorter time horizon or for retirees in drawdown phase.

After years of neglect as investors chased higher returns elsewhere or simply left money parked in cash, short-term bond funds are increasingly gaining attention from those looking for a safe investment with some return.

"Short-term bonds are now allowing you to pick up yield that you're still generally not getting in any savings account, unless you hunt around for it," said Dan Egan, director of behavioral finance and investments with online investment company Betterment. "And that yield is likely to go up over the next two to four years as interest rates in the U.S. continue to rise."

Interest rates have been marching steadily upward for months, and the Fed has indicated plans to raise interest rates twice more before year's end in an effort to temper inflation amid a growing economy and sustained job growth.

"There's been a sea change in the markets," said Matt Diczok, fixed-income strategist for Merrill Lynch and U.S. Trust. "The era of financial repression is over.

"For years the Fed funds rate had been well below inflation, so short-dated bond funds — any short-dated instruments —were losing money to inflation," he added.

Rising rates and the inflation that accompanies them, of course, can wreak havoc on bond returns overall, but rising rates have less impact on short-term bond funds. Plus, in today's market the flattening yield curve means there's less incentive to look to the longer term, since the premium for doing so is shrinking.

"We in the bond market think that money today is worth more than money tomorrow," said David Knutson, head of Credit Research Americas at Schroders. "Why would you want to extend your creditor a longer term, if you're not going to be paid that much more?"

That marks a big change from the market dynamics that have influenced investors for much of the past decade.

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"From post-crisis through 2017, investors in fixed income have had to move out along the curve to generate some yield, extending some duration risk, or taking a dip in quality," said Alfonzo Bruno, a research analyst for fixed-income strategies with Morningstar. "Now, we're seeing investors re-allocate and revisit their risk tolerance."

The ability to withstand both rising interest rates and inflation makes short-term bonds a relatively safe investment, particularly when compared with other investments, including equities, which have been on a roller coaster this year, bond strategies.

“This has been a very long-running bull market, people have a lot of gains, and a lot of people are feeling like the music might stop sometime soon, and so they want to decrease the risk in their portfolio, and short-term bonds are a good way to do that,” Betterment’s Egan said.

A well-balanced portfolio should always include a mix of asset classes with a diversity of both equities and bond funds. For those with a shorter time horizon or for retirees who are in draw down phase, shifting some of their cash allocation into short-term bond funds might make sense.

“A lot of retirees have a year or two of liquid assets on hand that they don’t really need,” said Rick Ferri, author of “All About Asset Allocation.” “They might have money coming in to their checking account from pensions or Social Security.

“They don’t need that much money coming in,” he added. “They could take some portion of that and move it into a short term bond fund, and pick up a little bit of income over the year.”

Egan agrees that recent market changes have made a short-term bond funds a viable place for investors to keep cash, knowing that it will likely at least earn a real rate of return beyond inflation, which can substantially erode the value of cash over time.

“Anybody who has cash sitting around in a savings account that they know they won’t need for a while should definitely be looking outside of their savings account, at some kind of a low-risk investment bond account,” he said. “Unfortunately, banks just aren’t incentivized to give you the best rate on your savings account, especially if you’ve been with them for a while.”

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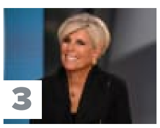

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