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Do You Still Need Bonds?

By Jilian Mincer

The value of bonds in almost every portfolio has been investing gospel for decades. But on the brink of what experts say could be the first big bond market crash in decades, a growing number of advisers and money management firms aren't so sure.

Recently, several advisers and big banks have dialed clients' bond holdings back – way back. In its "moderate risk" portfolios, Barclays cut its bond exposure from 20.5% to 13% and put the difference in equities. BNY Mellon Wealth Management has slashed some clients' bond holdings by 25%. Some independent advisers are going even further, reducing their clients' bond holdings to zero – even for clients who are close to retirement or otherwise risk-averse: "We pulled back on everything that wasn't going to come due this year," says Ted Feight, a financial adviser in Lansing, Mich., who remembers interest rates over 20% during the 1970s and 1980s. "I don't think there's any money to be made [in bonds] for a while."

This pullback has been months in the making. Fund investors have taken \$22.5 billion out of bonds since October, an abrupt reversal after almost two straight years of inflows. The change in strategy is being driven by mounting concerns about rising interest rates, inflation and credit defaults -- all of which are threatening to send the bond market tumbling. In an early sign of fissure, last week yields on the average 10-year Treasury bond jumped to the highest rate in ten months, a signal that the bond market is anticipating rising inflation – which would rapidly erode the value of bond investments.

Still, for advisers and their clients, the reversal is significant. The conventional wisdom of asset allocation dictates that almost everyone should have some bonds in his portfolio. Bonds, which are typically less volatile than stocks, add ballast to a portfolio, and for retirees, they provide substantial income. This is so widely accepted that in the most popular target-date funds -- premixed portfolios that are designed to get more conservative as the investor nears retirement age -- investors even 35 years from retirement have at least 15% of their portfolios invested in bonds. For investors 10 years from retirement, the allocation to bonds may be more than 45%.

But a growing number of advisers say this wisdom is out of date. One classic rule of thumb held that investors should have a bond allocation roughly equal to their age, so a 55-year-old would have 55% of her portfolio in bonds. That's simply antiquated, says Marc Schindler, a Houston-based financial adviser. Over the last two years, he's yanked his clients' assets out of U.S. Treasuries and junk bonds entirely. (In his personal portfolio, he's shorting them with an exchange-traded fund.)

Even for retirees, who are typically heavy bondholders, some advisers say there are better options now. Feight of Lansing, Mich., has been investing the proceeds of the bonds he sold in dividend-paying stocks and a reverse ETF called the ProShares Ultrashort 20-year Treasury (CONSOLIDATED:TBT) . "I have a lot of clients who are retired so they need income, and the same time they need growth," he said.

To be sure, plenty of people are still sticking to the old maxims. Big target-date fund providers Vanguard, Fidelity and T. Rowe Price have not dramatically changed their advice about bonds. At Charles Schwab, "We're telling clients that fixed income still plays a role in a balanced portfolio," says Rob Williams, the firm's director of income planning.

And still others see opportunity in the maligned bond market. Jack Bauer, the managing director of fixed income at Manning & Napier Advisors, says his firm recommends that clients trim bond holdings slightly, from 40% to 35%, but that "munis have been unjustly maligned." Santa Monica financial adviser Rose Greene says she's also buying municipal bonds. The yields are on par with, and in some cases higher than, Treasuries, says Greene, who's expecting returns of 5%, 6% or 7% this year. But if inflation increases, she'll sell too.