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When Smart Choices Are, Alas, Costly Ones

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SINCE the spring of 2004, it has seemed eminently sensible for bond investors to concentrate on mutual funds containing bonds with short average maturities. That is because the Federal Reserve has been raising interest rates, and investors have been aiming to prevent the erosion of their principal.

The Fed has raised its short-term benchmark rate in 11 quarter-point increments, to 3.75 percent. But in this case, being "right" has been costly. Elsewhere in the bond market, you could have made returns above the paltry, inflation-lagging 1 or 2 percent you were likely to have earned in short-term funds in the latest quarter and the year to date.

Instead of rising in tandem with short-term rates, long rates actually fell after the Fed started raising rates. That pushed up prices and confounded almost everybody from ordinary investors to Alan Greenspan, the Fed chairman, who described the situation as a "conundrum." Investors in funds holding bonds of intermediate and longer maturities did better; those who bought the conventional wisdom missed out.

"It's one of the rare times that we've seen interest rates rise and short-term funds actually underperform longer-term funds," said Eric Jacobson, a senior analyst at Morningstar who specializes in bonds.

It's also a prime example of how even canny investors, who know enough to avoid predicting stock prices, fool themselves into thinking that they can profitably foretell the future of bonds. Even if their view eventually proves correct, the payoff may take far longer than expected.

"Despite the evidence that even experts such as traders in the futures markets and professional economists have a poor record of predicting interest rates, many investors attempt to time the bond market by moving money in and out of bonds according to their expectations of short-term interest rate changes," an analysis by Fidelity Investments concluded earlier this year.

Historically, investors in bond funds have bought when returns were about to shrink and sold when returns were about to grow, said the Fidelity analysts, George A. Fischer and Shawn M. Verbout.

Wayne Wicker, chief investment officer at Vantagepoint Funds in Washington, said he was "amazed" at how the bond market's yield curve - the array of rates for maturities from months to decades, normally rising with longevity - has essentially flattened over the last year.

Low, tightly bunched returns have made it hard for bond managers to stand out from their peers, though some have done so by venturing into such things as bank loans, mortgages, asset-backed securities and high-yield, or junk, bonds, including those issued by newly downgraded General Motors and Ford. Some managers of ultrashort funds, in which expenses typically loom especially large relative to returns, have been notably inclined to reach for yield and thereby increase their exposure to credit risks.

One manager who has raised eyebrows for his apparent caution is Robert L. Rodriguez, chief executive of First Pacific Advisors, sponsor of the $1.9 billion FPA New Income fund. His portfolio has a duration - a maturity-related gauge of price sensitivity to changes in interest rates - of just over six months and has been one-third invested in cash or equivalents for the last 18 months.

Because of what Mr. Rodriguez considers irresponsible federal budget policy, there is simply too much inflation and other risk, with scant compensation, in lending money for an extended period.

"We believe that long-term bonds with yields here in the 4 percent, 3 percent region provide little, if any, value," he said. "The whole credit spectrum is mispriced."

If anyone should call such defensiveness the mark of a market-timing gunslinger, Mr. Rodriguez would respond that he is just the opposite. "We will deploy capital when we are getting compensated for the risk," he said. "In order to be correct longer term as an investment manager, you must be willing to accept periods of substandard performance."

FPA New Income was up 0.9 percent in the third quarter and 1.3 percent in the 12 months through September.

Jim Sarni, senior portfolio manager at Payden & Rygel Investment Management, takes a far more sanguine view of current prospects.

"What's going on is a great battle over inflation," he said, "with the Fed thinking that it's going to go up and be an issue and the market saying no, it isn't."

Mr. Sarni, whose company's Payden Short Bond and Payden Core Bond funds have eked out skimpy gains of less than 1 percent over the last 12 months, contends that while "headline" inflation is likely to pick up somewhat, it will mainly reflect temporary, hurricane-related oil and building-material price increases, with the core inflation rate remaining "fairly tame."

But a likely uptick in interest rates in a spooked market will be a chance to buy, he said. "I think what people should do is use the opportunities that will probably present themselves in the next month or two to begin to move out into that intermediate, two- to five-year part of the yield curve," he said.

"The one thing we know," he added, "is that when the Fed signals - whatever way they signal, probably this winter - that they are near the end of their tightening cycle, short rates are going to drop very dramatically and you'll see some attractive returns."

ACCORDING to the report from the Fidelity analysts, the wise course for those who think they can fathom the bond market's direction is to make "only small, incremental changes" that keep one's portfolio within 5 to 10 percent of a core allocation to fixed-income securities.

"It is unwise to time the bond market," the report said. "In practice, it is every bit as difficult and unrewarding as timing the stock market."

Mr. Jacobson of Morningstar emphatically agreed with the assessment in the Fidelity analysis that timing the bond market was unfeasible. "It's still amazing that after all we've been through during the last 15 years in the bond market that there are still people who say it's obvious that X is going to happen or Y is going to happen," he said. "Yet again they have been proven wrong or - just as bad - proved that it's impossible to know the timing."