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Flexible Bond Funds Offer Harbor as Rates Rise.

Funds with the flexibility to pick and choose among all categories of bonds are attracting investors' money–some of it at the expense of their more constrained peers–as fears of rising interest rates increase.

"I think the risk of losses from rising interest rates is at the top of most advisers' minds," said Nadia Papagiannis, director of alternative fund research at Morningstar Inc.

In many cases, investors are shifting money out of core bond funds into these so-called nontraditional bond funds, which have more tools available to navigate the now-treacherous bond environment, she said.

Investors, who since 2008 funneled billions of dollars into bond funds to avoid stocks and other riskier assets, have poured more than $21.46 billion into nontraditional bond funds this year through May 31, up from $5.82 billion in 2012 and $9.9 billion in 2010, according to Morningstar.

Interest rates have come into focus in recent weeks as investors try to gauge if or when the Federal Reserve will wind down its debt-buying program. The mere speculation has already prompted a spike in Treasury yields.

Rising rates mean big cuts to a bond's principal. But unlike core bond funds, which own U.S. investment-grade bonds, managers of unconstrained or "go-anywhere" bond funds have the ability to invest in a wide variety of fixed-income investments, including emerging-market, convertible, and municipal bonds.

Pimco Unconstrained Bond Fund (PUBAX), for example, normally seeks a duration–a measure of interest-rate sensitivity–from negative three years to positive eight years. The longer a security's duration, the more sensitive it is to interest-rate risk.

The Pimco fund can invest in a diversified fixed-income portfolio, including municipal bonds, mortgage-backed securities, U.S. government agencies, sovereign issues, convertible bonds, preferred securities and reverse purchase agreements, among other investments. It can also invest without limitation in derivative instruments, such as options, futures contracts and swap agreements.

The flexibility afforded managers of such funds makes it doubly important that advisers vet them well.

Avani Ramnani, director of financial planning and investment management at Francis Financial, said she has been using the Pimco Unconstrained Bond Fund for about a year.

"There's been fear of inflation kicking in for a long time," said Ms. Ramnani, whose New York firm manages just under $100 million. "It's really, really important for a portfolio to have that fixed-income exposure, but also the flexibility to get the right fixed-income exposure."

In a very conservative portfolio, she may invest as much as 15% of a client's assets in the unconstrained fund. But for a very aggressive equity-oriented portfolio, she might invest 2% or 3% of assets in the fund. She prefers to use the fund's institutional shares, which charge expenses of 0.90%, for clients when possible.

Yield is difficult to obtain in this environment, Ms. Ramnani said. She nevertheless considers the combination of yield and return when weighing a fund. The Pimco fund yields 2.85%, and has gained about 1.6% in the 12 months through Wednesday, while the Barclays U.S. Aggregate Bond Index has lost 1.2%, according to Morningstar.

For a client in retirement, the goal is to create a diversified portfolio and then determine the best place from which to take distributions, Ms. Ramnani said. With this year's huge stock gains, it made sense to take profits. In another year, higher bond yields may provide the needed cash, she said.

Beth Gamel, co-founder and executive vice president at Pillar Financial Advisors Inc., began using the JPMorgan Strategic Income Opportunities fund (JOSAX) in 2011 in combination with more traditional bond funds for clients who had relatively large allocations to taxable bonds.

For others, she had for years paired an intermediate-term or core bond fund with a shorter-duration bond fund. But last year, she saw the need for a tactical fund that could be more responsive to the bond market's changing conditions, and began using the JPMorgan fund more widely.

"Someone who has a requirement within their fund to be shorter duration isn't all of a sudden going to bring that duration down to six months or own different kind of instruments in their portfolio," as the opportunities fund can, said Ms. Gamel, whose Waltham, Mass., firm manages $603 million.

The fund's opportunistic approach, along with its one-year duration, provides protection on the downside and some participation on the upside, Ms. Gamel said. She feels confident that William Eigen, the fund's manager and a former hedge-fund manager, is capable of moving in and out of different markets effectively.

The fund yields 3.3%, and has gained 5.5% in the 12 months through Wednesday, according to Morningstar.

Among the nontraditional bond funds Ms. Papagiannis of Morningstar likes are Driehaus Active Income (LCMAX), Driehaus Select Credit (DRSLX) and BlackRock Global Long/Short Credit (BGCAX).