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6 Questions Bond Investors Should Be Asking Right Now.

As interest rates rise, finding the right fixed-income strategy is crucial

The Federal Reserve is raising interest rates, and there are several questions that savers and bond investors would like answered.

For example, to be blunt: *Is my savings account going to pay any worthwhile interest at some point?!* (The answer: probably not soon. But there are alternatives.)

If this all sounds familiar, it should: Many bond-market strategists had expected bond yields would be a lot higher by this point in the economic recovery, perhaps even making a savings account desirable. But a climb in rates seems to be getting closer.

With inflation ticking higher, the Fed now anticipates lifting short-term rates more rapidly. Officials also are discussing winding down the Fed's huge bond portfolio, accumulated during the recession to damp yields. Such a move would eliminate a major source of demand for government bonds, whose prices fall as yields rise.

And meanwhile, Washington lawmakers are talking about tax cuts and infrastructure spending that could stoke growth and lift inflation.

Amid such developments, "you need to be really careful about how you invest the fixed-income part of your portfolio," says Terri Spath, chief investment officer at Sierra Investment Management in Santa Monica, Calif.

She and others say there are some smarter ways to play this: Avoid putting any cash that might be needed soon into bonds. Keep additional funds around to invest later, at potentially higher rates. Dial back on rate-sensitive holdings, and further limit risk by owning a range of U.S. and foreign bonds.

Here are six questions for savers and those who own bonds or are considering buying them:

1. What risks do rising rates pose for bonds now?

One threat is to short-maturity bond funds and exchange-traded funds, which some investors may think are immune to rate risk. These commonly have average maturities of around two years and aim to generate 1% to 2% in annualized yield.

After raising rates twice since last fall, Fed officials expect to boost rates another five or six times by the end of 2018, lifting the Federal Reserve's rate target to around 2.25%-2.5% from about 1% now.

Bond yields move the opposite way as prices. Although short-term funds are less affected by yield changes than those that own longer maturities, many have a rate sensitivity of around two. If yields rose by one percentage point, that would result in a 2% decline in principal value—more than an investor would get back in interest paid by such a fund.

"If you are an investor who really can't stomach any losses, you should be in a money-market fund" where principal value would remain steady, says Emory Zink, analyst at fund-trackers Morningstar Inc.

2. Where can investors get reasonable returns on cash?

Although short-term rates are rising, banks—not the market—decide what rate of interest they will pay on savings. The national average rate today is just 0.08%, and banks will raise rates slowly since doing so will boost their profitability.

Some money-market funds yield closer to 1%. Their yields will rise gradually, though lagging behind the Fed's rate increases.

For the best combination of yield and safety, investors might consider putting money into a high-yielding, federally insured bank savings account, says Bankrate.com chief financial analyst Greg McBride. Such accounts are offered by virtual institutions that are courting depositors. Two such banks, Goldman Sachs Group Inc.'s GS Bank and the CIT Bank unit of CIT Group, are advertising rates above 1%.

3. Which bonds offer some protection against rising rates?

One way to diversify against U.S. rate risk is with bonds issued in other countries whose rate cycles aren't in sync with that in the U.S. Raman Srivastava, managing director for global fixed income at Standish Mellon Asset Management Co., cites emerging-markets bonds as among "the more compelling opportunities" after investors fled such bonds several years ago. Yields can top 5%, offering a bigger offset to the impact of rising yields.

Moving lower on the U.S. credit ladder is another solution. High-yield bonds (or junk bonds) issued by companies with weaker credit ratings can yield more than 6%.

But be cautious about loading up on such securities to the exclusion of higher-quality bonds. While higher-yielding bonds are less vulnerable to rising yields, they are very sensitive to worries about defaults and can be volatile, notes Scott Kimball, portfolio manager of BMO TCH Core Plus Bond Fund (BATCX). In 2015, he says, some high-yield bonds issued by energy companies plunged in price during the oil-market swoon.

4. How can investors lock in better income as rates rise?

Traditionally investors did that by building a ladder of bonds having sequential maturities. As the nearest matured, the proceeds were reinvested in a new bond due to mature several years later, when the investor hoped to reinvest at an even higher yield.

Alternatively, an investor could build a ladder with defined-maturity bond ETFs, says David Berman, chief executive of Baltimore-based wealth manager Berman McAleer. Unlike conventional bond ETFs, which periodically buy new bonds to replace maturing ones, defined-maturity ETFs own bonds with closely bunched maturities. After all the bonds mature, the ETF repays principal and interest.

Mr. Berman uses Guggenheim BulletShares ETFs, which are available in either investment-grade or high-yield corporate versions. BlackRock's iShares unit offers defined-maturity ETFs that own taxable corporate bonds or tax-exempt municipal bonds.

5. What are the alternatives to fixed-rate bond funds?

Floating-rate funds—sometimes called senior-loan or bank-loan funds—can be a good defensive play when rates are rising.

Such funds own loans made by banks to companies with lower credit ratings and yield 4% or more. The rates on the loans periodically adjust up or down, based on changes in a benchmark index such as the London interbank offered rate, or Libor, so a fund's yield moves higher as rates rise.

One concern is that surging demand for such funds is enabling companies now to get much more lenient borrowing terms, says Frank Ossino, who oversees Virtus Senior Floating Rate Fund (PSFRX) at Newfleet Asset Management, in Hartford, Conn. Mr. Ossino cautions that another downturn eventually could spark defaults on lower-grade loans, denting a fund's returns. Funds that yield more than peers may own a larger percentage of such loans, he says.

Among senior loan funds that Morningstar rates highly are Eaton Vance Floating-Rate (EVBLX), Lord Abbett Floating Rate (LFRAX) and Fidelity Floating Rate High Income (FFRHX).

6. Are mutual funds or ETFs better at this point in the cycle?

Active managers can reposition a portfolio to trim rate risk, moving to bonds that are less rate-sensitive. But ETFs may be a good choice because they charge much lower management fees—a benefit at times when bond returns are slim by historic standards.

Still, people who plan to buy an ETF need to understand what they are getting, says Josh Jalinski, an adviser in Toms River, N.J. ETFs that focus on certain narrower sectors, such as iShares 20+ Year Treasury Bond ETF (TLT), can be volatile, posing more risk of mistiming a purchase or sale, he says.

Some ETFs hedge against rising rates. They include WisdomTree Barclays Interest Rate Hedged U.S. Aggregate Bond Fund (AGZD), which yields about 2%, and Deutsche X-trackers Investment Grade Bond Interest Rate Hedged ETF (IGIH), which recently yielded about 3¼%.

Hedged funds outperform when rates rise, but may underperform when rates are falling, says Todd Rosenbluth, director of ETF and mutual-fund research at CFRA, a New York-based provider of investment research. "By hedging, you protect against something, but also you can miss something," he says.

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