

Bond Funds Take on Risk To Lift Returns

Customary Safe Havens

Look to Branch Out

As Rates Remain Low

By SHEFALI ANAND

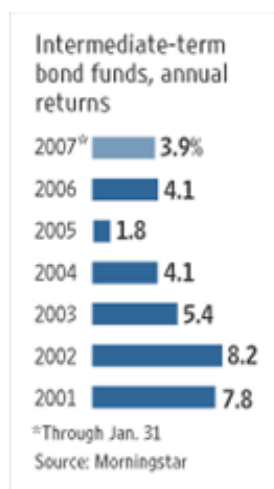
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(See *Corrections & Amplifications* item [below](#).)

Investors who haven't looked inside their bond funds lately may be surprised at a few things in these supposedly relative safe havens.

Many bond-investing mutual funds now put a sizeable chunk of money in bonds tied to mortgages -- this at a time when the housing market has been losing a lot of steam. Others have bought bonds of financially struggling automobile companies like **General Motors Corp.** and **Ford Motor Co.**

These investments -- which can be riskier than the usual fare like U.S. Treasury bonds -- are showing up more often in some bond funds as money managers scramble for ways to boost returns at a time when interest rates on more traditional bond-fund investments remain low.



For investors, it highlights the need to pay attention to shareholder letters and other mutual-fund literature to figure out if the fund manager is dipping into riskier bonds. If a manager sounds "too enchanted" with higher-yielding but lower-quality bonds, "then that would give me pause," says Jeff Tjornehoj, an analyst at Lipper Inc.

Traditionally, so-called "core" or "total return" bond funds spread their investments across government and corporate bonds and other safer types of investments. However, the funds often have the ability to put some money elsewhere, too. And with yields on the 10-year U.S. Treasury note hovering near 4.84%, they're feeling pressure to branch out.

One popular strategy has been to push into mortgage-backed securities, which are home loans repackaged into bonds. Fund managers have been lapping them up in the past couple of years -- some investing half or more of their portfolio -- hoping to earn higher yields than many corporate bonds or U.S. Treasury bonds.

"You're buying mortgage-backed securities for the additional income, not for a dramatic price return," says Tom Dugan, one of the managers of the Dodge & Cox Income fund. The \$12 billion fund has added mortgage-related securities significantly in the first half of 2006, bringing up its position to about 40% of the portfolio.

Cooling housing prices haven't affected mortgage bonds much -- so far. That's because a majority of these bonds are guaranteed by government-backed Ginnie Mae or by government-chartered agencies Fannie Mae and Freddie Mac, and thus have low risk of default.

However, these bonds face risk if interest rates were to fall sharply. That would cause mortgage-holders to prepay their loans -- causing the price of the mortgage-backed securities to then tumble.

There's another risk, too. If interest rates rise sharply, some kinds of mortgage securities can lose value. That's because fewer homeowners will prepay their loans, and bond investors have to wait longer to get their money back, which they could potentially have invested at higher rates.

Rising interest rates have hurt bond-fund investors in the past. In 1994, two government-bond mutual funds -- from Paine Webber Group Inc. and Piper Jaffray Co. -- lost heavily due to their investments in mortgage-backed derivative securities after the Federal Reserve started raising interest rates that year.

There's a higher risk of default with mortgage securities issued by private companies. Unfortunately, it's tough for fund investors to tell which kind a particular fund is holding.

Bond-fund managers counter that they've had to be very selective in finding corporate securities. Some bonds appear too expensive, they say, given that corporate earnings growth has been slowing down. Also, companies in general have been adding to their debt, which reduces the value of the existing bonds.

At the \$2.12 billion Metropolitan West Total Return Bond Fund, managers have actually cut their exposure to corporate bonds from 32% of the portfolio in 2006 to about 23% currently. Tad Rivelle, one of the fund's managers, says they've been investing in corporate bonds either backed by assets, or else which have strong protections for bondholders -- for instance, prohibitions on the companies to add too much new debt.

These include real-estate investment trusts (REITs), which acquire and manage properties like offices, malls and apartment buildings. REITs have several restrictions for adding debt, which makes their debt attractive in the current low-interest-rate environment. (The reason: Low interest rates make it easier for companies to borrow more -- a move that undercuts the value of their existing

debt.)

In the past year, these bonds have appreciated also partly because of the booming interest among buyout firms for acquiring REITs.

"They've had to come to us and buy our bonds back at premium" prices, says Ford O'Neil, manager of the \$3.2 billion-Fidelity Total Bond fund, which owns such bonds.

Another source of returns last year were bonds of auto companies like Ford and GM, which were downgraded to "junk" or low-quality status in 2005 because of the companies' financial troubles. Fund managers who bought their bonds made money last year, as their prices rose.

In general, last year junk bonds were among the better performers, though some market watchers think their bull run might be ending.

Marsh to Sell Putnam

Marsh & McLennan Cos. signed a definitive pact to sell its Putnam Investments division to Great-West Lifeco Inc., a unit of Montreal's Power Financial Corp., for \$3.9 billion.

Putnam is Marsh & McLennan's mutual-fund business, with \$192 billion under management. The sale is part of Marsh & McLennan's effort to retool the company following the fund-share-trading scandal.

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Corrections & Amplifications:

Bond mutual funds classified as "core" or "total return" have in the past invested in bonds tied to mortgages, but some are now putting more money into these investments. This column doesn't specify that these types of funds have held these bonds in the past. The article also incorrectly states that if interest rates fall sharply, the price of mortgage bonds will fall; in fact, the price will rise, but to a lesser degree than other types of bonds.

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