

## business: MAKING CENTS

## HOT TIPS for Interest Rates

As higher interest rates become more likely, investors need to review their bonds, bond funds, and other fixed-income investments to identify areas of interest-rate risk, and evaluate strategies to deal with the challenges of this new environment.

Bond I.Q. remains depressing low. A recent survey of 400 investors by a major mutual fund family found 44% thought the longer a bond's maturity, the less sensitive its price to changes in interest rates. A quarter believed that bond prices rise with interest rates. Of course, in both cases the exact opposite is true.

A good metaphor to express the relationship between interest rates and bond prices is a seesaw, with interest rates on one side and bond prices on the other. As one goes up, the other falls. To understand the effect of maturity on this equation, imagine the length of the see saw as the maturity of the bond. A longer see saw (or maturity) would move further in its arc, up or down, than a shorter one. Thus the reaction of bond prices to a given move in rates is greater as the maturity increases. Bond funds work the same way.

Shortening maturities on bonds or bond funds is one way to lessen price volatility, but your income will suffer. Another strategy, known as "laddering," involves spacing bond maturities over a series of years. Use \$200,000 as an example. You might buy a \$25,000 bond due in each year beginning in 2005 and ending in 2012. Since rates are generally higher as you go further out, this will give a better overall yield than that offered by shorter-term issues. Most important, having a bond mature each year in the future can offer some protection from falling bond prices. This will increase your income, protect your principal, and make the change in interest rates work for you, rather than against you. Another popular approach, called a "barbell" strategy, combines the same concept of laddered maturities for a part of your funds, with a purchase of longer-term bonds with the balance.

TIPS, or ten-year Treasury Inflation Protected Securities, have been drawing increased attention from investors in this new uncertain environment. While traditional bonds perform poorly in an inflationary environment with rising interest rates, your principal in a TIPS is indexed to inflation, and the bond guarantees a specified real return no matter what the inflation rate may be. TIPS can be purchased directly from the Treasury, from a broker, or through a mutual fund, like the American Century Inflation Adjusted Bond Fund (Acitx) the Pimco Real Return Bond Fund (Prtnx), and the Vanguard Inflation-Protected Securities (VIPSX). More information is available on TIPS at the U.S. Treasury Web site, <http://www.publicdebt.treas.gov/sec/sec.htm>.

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