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Short-Term Bond Funds Not Immune to Selloff

By DAISY MAXEY

Even short-term investment-grade bond funds, seen as one of the fixed-income market's safest corners, haven't been immune from the selloff fueled by fears the government will soon trim its bond-buying program.

For the first five months of the year, short-term investment-grade bond funds were the bond market's defensive darlings. For the year through May, according to Lipper, investors poured $12.7 billion into the funds, which buy bonds with a relatively low risk of default that mature within one to three years.

Because they mature relatively soon, short-term bonds are seen as less vulnerable to interest-rate increases, which drive down bond prices. Many investors have been shifting from intermediate- and long-duration funds into short-duration funds.

But when the Federal Reserve signaled in mid-June it could taper off its bond buying later this year, bond funds saw big net outflows--and even short-term investment-grade bond funds were hit.

According to data from Lipper, in the week ending June 26 investors pulled a net $126 million out of short-term investment-grade bond funds with a total of $77 billion in assets. Those funds represented about 40% of total assets in this fund category; the other funds will report their activity later in July, Lipper said.

Assuming those funds also saw net outflows, it would be the first time the fund category saw more money leave than come in since November 2011. Jeff Tjornehoj, a senior research analyst at Lipper, said he wouldn't be surprised to see the selling continue.

"Financial advisers and investors are showing some concern around recent losses," Mr. Tjornehoj said. "The market in general is trying to reprice risk once again without a major buyer."

New York-based Altfest Personal Wealth Management, an advisory firm that manages $911 million, has been shifting some of its bond holdings from short-term funds to municipal bonds, where yields had become attractive.

Altfest moved from an "overweight" position on short-term bonds to a "neutral" position, said Gregory Lavine, a senior financial adviser at the firm. For now, investors in short-term bond funds are probably fine, said Mr. Lavine, but when the Federal Reserve begins to raise rates, which may happen in 2015, "the short end of the curve will go up pretty rapidly and you'll see some of these funds go down in price pretty rapidly."

Short-term bond funds have lost 0.43% on average this year, but still show gains of about 1.3% in the 12 months through July 2, according to Morningstar Inc. MORN -0.23%But if and when interest rates increase, there is the unattractive prospect of losing 2% or 3% in principal value, Mr. Lavine said.

"We don't think it's a place to be overweight if it's your safe money," he said.

Still, the bond fund market offers few other options in terms of price stability. Brian Goodstadt, an investment adviser with Paragon Capital Management in Denver, Colo., has a small position in the Riverpark Short Term High-Yield fund (RPHYX) as a way to keep clients' cash from earning nothing. And he expects "these funds will just get hit less" than a long-duration fund if rates rise.

Mr. Goodstadt said he doesn't expect a significant hike in rates for a few more years. "We just saw a big spike up," he said. "I think it's mostly done, but that is a risk."

Chad Carlson, an adviser at Balasa Dinverno Foltz LLC, has used the Vanguard Limited-Term Tax-Exempt Fund (VMLUX) in client portfolios for years, and put more assets into the fund about 16 months ago. About 40% of clients' municipal-bond exposure may be in the fund now, depending on their risk profile, up from a more typical 25%, he said. The fund has a duration of about 2.3 years and yields a little less than 1%, he said.

"We're getting paid to take some risk, but the interest rate is not where we're getting paid a lot to take that risk," said Mr. Carlson, whose Itasca, Ill., firm manages $2.4 billion.

The Vanguard Limited-Term Tax-Exempt Fund has lost 0.48% this year, but gained 0.35% over the 12 months through July 2, according to Morningstar.

"We're very aware that our clients aren't used to losing money on bonds," Mr. Carlson said. "That's supposed to be the defensive part (of the portfolio), and that hasn't been the case in the last month and a half.

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