The New York Times | http://nyti.ms/1x5jyji

MUTUAL FUNDS

For Bond Investors, That Other Shoe Still Didn't Drop

By CARLA FRIED JAN. 9, 2015

BONDS confounded conventional wisdom in 2014 with a much-better-than-expected return.

"If you asked anyone at the beginning of 2014 where the rate on the 10-year Treasury would end the year, I don't think anyone would have said lower, and most would have said one percentage point higher," says Stephen Kane, a group managing director at TCW, which manages $110 billion in fixed-income portfolios, including the Metropolitan West Total Return Bond fund.

Yet the bellwether Treasury note ended 2014 at 2.17 percent after starting it at 3 percent. And while the United States economy showed some vigor — typically a trigger for rates to rise — global investors fleeing weakness in other markets were eager to buy American bonds. That demand pushed bond prices higher and yields lower.

The upshot is that last year was frustrating only for the bond bears who have been waiting since 2009 for interest rates to rise from the abnormally low levels manufactured by Federal Reserve policy.

Morningstar's index of intermediate-term core bond funds — the high-quality portfolios that are the heart of most retirement plans — had a total return of more than 5 percent in 2014. Total return is the sum of the income (the yield) the fund earned and any changes in the underlying price of bonds in the portfolio. The five-year annualized gain of 4.8 percent for the index of core bond funds was also anything but bad news.

Yet if you've followed the predictions of many bond experts since Fed policy pushed interest rates low during the financial crisis, you might think that core bond funds and exchange-traded funds — especially those that closely mimic the look and feel of the benchmark Barclays U.S. Aggregate Bond index — are supposedly ill-equipped for today's world.

A common warning is that core bond funds, with an average duration of more than five years, will suffer bigger price declines than funds with shorter durations. Duration is a measure of a fund's sensitivity to changes in interest rates; when rates rise, a fund with a longer duration will have steeper price declines than one with a shorter duration. That's absolutely true. But hiding out in short-term bond funds with their lower yields has its own opportunity cost. The 2.3 percent average annualized gain for playing it safe in short-term bonds over the last five years was less than half the return of core bond funds.

And if history is any guide, even when rates do rise, the higher income payouts from a core bond portfolio offset the price declines over time. From the end of 1948, when an intermediate-term government bond yielded just 1.5 percent, to the end of 1981, when it almost reached 14 percent, the annualized total return was still around 4 percent, according to data from Ibbotson Associates, a unit of Morningstar.

Another common criticism of high-quality bond funds is that they are heavily invested in areas of the market that are now the most expensive: United States Treasuries and government-backed mortgage bonds. But that conversation often doesn't mention that high-quality bonds are best equipped to provide risk-damping diversification when stocks plunge.

"Bonds have been like a high-scoring basketball player, riding the long decline in rates, and that's what everyone focuses on," says Craig Israelsen, who teaches in the financial planning program at Utah Valley University.

Over the very long haul — from 1981 through 2013 — the average intermediate-term government bond had an annualized gain of 8 percent, according to Ibbotson data. That sort of performance may be off the table now that rates have little room to move lower. But what remains intact is the ability of high-quality bonds to do well when stocks swoon.

"High-quality bonds will continue to be a valuable teammate in diversified portfolios," said Mr. Israelsen, whose research on the long-term role of bonds in a portfolio has appeared in the AAII Journal (a publication of the American Association of Individual Investors) and Financial Planning magazine.

Defense could be especially valuable right now.

"We'd argue that the role of high-quality bonds is more important today because the valuations on equities are higher than where they were in 2008 and 2009," said

Joe Davis, chief economist at Vanguard and head of its Investment Strategy Group. Though few suggest that a stock bear market like the one in 2008 is in the offing, the relative performance of stocks and bonds illustrates the value of bonds in such times of stock market stress: In 2008, the Vanguard Total Stock Market Index fund lost 37 percent, while the Vanguard Total Bond Market Index fund gained 5.2 percent.

And don't expect the new breed of bond funds that flaunt a go-anywhere approach in pursuit of yield and returns to provide the same downside protection. According to Morningstar, these funds, on average, have about one-third of their assets invested in bonds rated below investment grade, also known as high-yield or junk bonds. Such bonds tend to move more in sync with stocks than with Treasuries; in 2008, an index of high-yield bonds lost more than 26 percent.

"When equities are going down, unconstrained bond funds may not provide traditional diversification," said Mr. Kane at TRW.

The average high-grade intermediate-term bond fund has less than 6 percent of its assets invested in lower-quality bonds. Funds and E.T.F.s that track the benchmark Barclays U.S. Aggregate Bond index do not invest in bonds rated below investment grade.

This doesn't make go-anywhere funds a bad choice. "It's just a matter of having eyes wide open to the credit risk you are taking on," said Mr. Davis at Vanguard.

For example, Dan Ivascyn and Alfred Murata, co-managers of the Pimco Income fund — and Morningstar's 2013 fixed-income managers of the year — currently eschew Treasuries and mortgage bonds that are guaranteed by Freddie Mac and Fannie Mae.

"Those are the bonds the Fed's bond-buying program focused on and has driven to very expensive levels," Mr. Ivascyn said.

They are finding better values in mortgage-backed bonds that lack a government guarantee. Mr. Ivascyn said such bonds would have more volatility than government bonds but were less risky than traditional junk bonds. He expects these nonagency mortgage bonds to deliver returns of around 5 percent. "That's double what the 10-year Treasury pays."

Over the last five years, Pimco Income's annualized total return of more than 11 percent is more than double the return for the iShares Core U.S. Aggregate Bond E.T.F., which closely tracks the Barclays index. And that came with roughly 40 percent more volatility than the benchmark index.

OCCUPYING a middle ground between high-grade, index-tracking bond funds and the go-anywhere crowd are actively managed funds, with a limited mandate to venture beyond the types of bonds tracked by the Barclays aggregate index. The ability to deviate from the index has proved effective recently: According to S&P Dow Jones Indices, nearly 60 percent of core bond funds managed to outperform the index over the five years through June 2014.

The actively managed Fidelity Total Bond fund currently has 15 percent of its assets invested in high-yield and emerging-market bonds; that's below the fund's self-imposed 20 percent limit for nontraditional pockets. Over the five years through 2014, Fidelity Total Bond's annualized gain of 5.4 percent was nearly a percentage point ahead of the Barclays aggregate index. In the rough market of 2008, the fund lost 5.6 percent.

"It comes down to deciding what you want from bonds," said Mr. Israelsen at Utah Valley University. "If you value diversification, you should stick with classic high-grade funds. If you want higher yield and returns, just understand what you're buying into."

A version of this article appears in print on January 11, 2015, on page BU16 of the New York edition with the headline: For Bond Investors, That Other Shoe Still Didn't Drop .