


**October 21, 2005**

## FUND TRACK

### DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: [www.djreprints.com](http://www.djreprints.com).

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

# If Rates Rise, Bond 'Shorts' Are Set to Cash In

By **MARK WHITEHOUSE** Staff Reporter of THE WALL STREET JOURNAL *October 21, 2005; Page C1*

For bond investors who think long-term interest rates will rise soon, some mutual funds offer a solution: Go short.

These funds are positioned to make a profit from rising rates and falling prices on existing bonds. That scenario is bad news for most bond funds, which own bonds outright, but not for funds that use a short strategy, which involves making bets that do well when bond prices don't.

Bond shorts have gotten clobbered in the past year as long-term interest rates have remained low. But amid predictions from the pros that long-term rates will rise, at least three new funds that short bonds have hit the market this year. And the tide finally seems to be turning, with the funds generally doing better in recent months.

Long-term rates are "incredibly resilient right now, but it seems like they're poised to move higher," says Greg Peters, chief U.S. credit strategist at Morgan Stanley in New York.

These funds aren't for everybody. Because shorting involves betting on how interest rates will move in the near future, long-term investors seeking to build retirement nest eggs tend to avoid the strategy, which is more commonly used by sophisticated investors such as hedge funds. The fees also are higher than the average bond fund.



### BEAR BONDS

[See more](#) about the performance of funds that bet bond prices will fall.

"Bond-fund investors tend to be a pretty conservative group," says Scott Berry, a bond-fund analyst at

Morningstar Inc. "They're not going to get into a lot of market timing, betting on the direction of interest rates."

But for those who want to make a bearish bet, there are several ways to go. Rydex Investments' Juno Fund, the biggest and oldest of bond funds that go short with more than \$2 billion under management, seeks to provide a return equal to any drop in the price of the 30-year Treasury bond, which moves more than other bonds in response to a change in rates. The fund does so either by selling futures contracts, which represent a promise to deliver a bond at a specified date, or by borrowing 30-year bonds and selling them, in the hopes of repaying the loans with bonds purchased at a lower price.

Three other funds use similar strategies to short Treasuries. Rising Rates Opportunity, managed by ProFunds Advisors LLC, shorts the 30-year bond. Rising Rates Opportunity 10, launched by ProFunds in January, and ContraBond Fund, launched last year by Rafferty Asset Management LLC, short the 10-year Treasury note. Rising Rates Opportunity and ContraBond both use leverage, which means they make their bets with borrowed money that magnifies gains when rates go up and magnifies losses when rates fall.

Two new funds allow individual investors to short the market for high-yield, or junk, bonds issued by risky companies: Access Flex Bear High Yield Fund, launched in April by ProFunds, and Potomac High Yield Bear Fund, launched in September by Rafferty. They use derivatives instruments called credit-default swaps to profit when bond prices fall.

Even as the Federal Reserve has raised short-term rates to 3.75% from 1%, long-term rates remain lower than they were 16 months ago. As a result, the year-to-date returns on funds that short bonds look pretty bad. As of Wednesday, for example, Juno was down 2.82% for the year, and Rising Rates Opportunity was down 4.79%, according to Morningstar Inc.

"I've certainly been bearish for longer than I should have been," says Dan O'Neill, managing director of Rafferty. He says ContraBond fund has eked out a positive return of 2.08% so far this year.

The small gap between short-term and long-term interest rates, however, does offer one advantage: It reduces the cost of shorting. When fund managers borrow long-term bonds and then sell them, they must pay the interest rate on the bonds to the lender. But they also earn interest at short-term rates on both the fund investors' cash and the proceeds from the bond sales.

When long-term rates are a lot higher than short-term rates, they pay more in interest than they receive, adding two to three percentage points to a fund's total expenses. But when short and long rates converge as they have in recent months, the funds can actually receive more in interest than they pay out. "As a consequence, shorting bonds is not nearly as risky" as it usually is, says Mr. O'Neill.

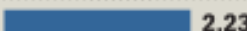
Lately, high fuel prices and the government's plans to spend hundreds of billions of dollars rebuilding areas hit by hurricanes Katrina and Rita have increased concerns about inflation. That is good for Treasury-bond bears, because investors demand more return on longer-term bonds to compensate for the added inflation risk. The yield on the 10-year Treasury note stood at about 4.45% in late trading yesterday, up from about 4.02% on Sept. 1 -- a fall in price of about 3.4%. The price of the 30-year bond has fallen about 5.4% over the same period.

Meanwhile, problems in the auto sector, such as the bankruptcy of auto-parts maker Delphi, have made investors jittery about holding high-yield bonds. The credit spread on the average junk bond -- the added interest a company pays over and above that paid by the government on Treasury bonds -- is now about 3.6 percentage points, compared with less than 3.3 percentage points in late July. And if the Fed's rate increases and higher fuel prices cut into consumer demand, companies could have less cash to make bond payments and more could renege on their debts, which is good for shorts too.

Still, fund managers caution that periods of volatility, or even flat interest rates, can be costly. The funds charge investors management and other fees ranging from 1.32% to 1.75% of assets, compared with 1.11% for the average bond fund. Minimum investments range from \$10,000 to \$25,000.

"You don't want to be in this fund in a volatile market," says Anne Ruff, portfolio manager for the Juno fund. "You want to come into this fund when there's more certainty of interest rates rising at a steady clip."

Write to Mark Whitehouse at [mark.whitehouse@wsj.com](mailto:mark.whitehouse@wsj.com)<sup>1</sup>

MUTUAL FUND NAME	YEAR-TO-DATE		ASSETS IN MILLIONS	FEE <sup>5</sup>
	RETURN <sup>4</sup>	THREE-MONTH RETURN <sup>4</sup>		
<b>ProFunds Rising Rates Opp</b>	-4.79%	 4.15%	\$488	1.42%
<b>ContraBond</b>	2.08	 3.83	40	1.75
<b>Rydex Juno</b>	-2.82	 3.73	2,046	1.32
<b>ProFunds Rising Rates 10<sup>1</sup></b>	N.A.	 2.23	20	1.55
<b>Access Flex Bear High Yield<sup>2</sup></b>	N.A. -0.8%		143	1.55
<b>Potomac High Yield Bear<sup>3</sup></b>	N.A.	N.A.	6	1.75

<sup>1</sup>Launched in January <sup>2</sup>Launched in April <sup>3</sup>Launched in September <sup>4</sup>Returns through Wednesday <sup>5</sup>Not including cost of short positions  
Sources: Morningstar; fund management

URL for this article: <http://online.wsj.com/article/SB112984760028474936.html>

Hyperlinks in this Article: (1) <mailto:mark.whitehouse@wsj.com>

Copyright 2005 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit [www.djreprints.com](http://www.djreprints.com).