

THE WALL STREET JOURNAL.*Article 1 of 1***Credit Markets****Seeking Safety in Bonds? They Have a Wild Side, Too**

By Gregory Zuckerman

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So, are you ready yet to bet on bonds?

With stocks getting pummeled, some individual investors searching for safer returns are peeking over the stock fence at what bonds are doing. But bonds aren't just for the faint of heart -- big bucks are made and lost every day betting on sharp moves in the bond market.

Investors' interest in bonds is likely to continue, with the economy slowing and the Federal Reserve gearing up for what are likely to be more interest-rate cuts. Investors again are realizing the importance of having, as a cushion, at least some retirement-fund money in bond-focused mutual funds. And thanks to online bond trading, it is easier and cheaper for investors to trade individual bonds on their own.

Chris Lynch, an entrepreneur in New Canaan, Conn., has been buying municipal bonds for much of the past month, going online to buy with Charles Schwab & Corp., undeterred by yields on the bonds below 5%. Yields fall as a bond's price rises.

"When the Nasdaq is going down 5% a day, that [5% return] feels like 20%," Mr. Lynch says, noting that gains from municipal bonds are tax-free. In fact, most kinds of bond-focused mutual funds, which is the way many small investors buy an exposure to bonds, are up 2% to 6% so far this year. Nearly all stock categories are down.

Should a small investor buy individual bonds as Mr. Lynch did, or invest in the bond funds managed by the pros? Treasury bonds can be easily bought online or from a broker (or right from the Treasury Department if it is a new issue) but for corporate bonds or munis, many experts recommend bond funds, which hold a group of bonds and spread out the risk.

Bonds aren't fail-safe, of course, despite their stodgy reputation. For example, long-term corporate bonds and those of quasi-government agencies, such as Fannie Mae, probably will do well if the Fed keeps cutting rates, according to some analysts. The downside is that Treasury-bond prices are at two-year highs already, as investors have factored in a Fed rate-cut next week. So, unless there is a difficult recession, and stocks keep tumbling, it may be tough to profit.

And if the economy recovers, watch out! That is because the Fed could stop cutting rates and investors will shift from bonds to stocks once again.

Yesterday delivered the latest hint at the possible advantages of bonds. The Dow Jones Industrial Average fell 3% to drop below the 10000 mark after being down even more earlier in the day, and the Nasdaq Composite Index fell another 2%. But the benchmark 10-year Treasury note rose 22/32 point, or \$6.88 per \$1,000 invested, to push down the yield to 4.843%.

"The opportunity is there if the economy slows down even further over the coming year and the Fed lowers rates further," says Marilyn Cohen, president of Envision Capital Management Inc. "But the next rate cut is already priced into bonds, and if you're going to play bonds for a pop you need to count on even more interest-rate cuts between now and the end of the year."

Because bond prices move in the opposite direction of their yields, a bet on bonds can pay off if rates keep falling. The Fed is expected to cut its key short-term interest-rate target, the federal-funds rate, half a percentage point to 5% next week. But some analysts figure there could be more of a cut. If the economy continues to weaken, even more rate cuts could be in store, potentially sending the fed-funds rate to as low as 3.5%, some argue. More troubles for stocks also will cause investors to shift to the safety of bonds, giving prices another boost.

If the Fed cuts rates aggressively, investors could be best rewarded buying long-term bonds, such as the 30-year Treasury bond.

"Long-term bonds get you more bang for the buck," says Ms. Cohen. "I would not be surprised to see the [30-year] bond below 5% later this year. All the bad things in the economy are going to get worse, so it could happen." If the 30-year bond's yield, now 5.277%, drops below 5%, that could add up to gains topping 15%, Ms. Cohen says.

More-aggressive investors could turn to "strips," or zero-coupon bonds, among the most volatile of all Treasury securities. These bonds pay no interest but are sold at a steep discount and make a payment of principal at maturity. If bonds rally, and inflation remains under wraps, these investments will jump. Warren Buffett

has made big bucks with this strategy in the recent years.

Investors wary of buying bonds on their own could turn to mutual funds offered by mutual-fund families such as Rydex and American Century that focus on zero-coupon bonds.

"If we get any good economic news, there will be massive losses for long-term bonds," warns Ms. Cohen. That is why many analysts recommend 10-year and five-year Treasuries and safer corporate and agency bonds for those unwilling to take on too much risk. Shorter-term securities, like two-year Treasuries, are also a good way to bet on lower rates without the risk of losing big if it doesn't happen.

"We're not recommending that investors buy long-term bonds right now, there's too much risk," says Ron Lara of Lara Group, a money-management firm that has averaged a 12.25% return in the past five years trading Treasuries. "People are buying Treasuries because they're scared, there's a flight to quality, but once the stock market turns later this year money will come out of Treasuries. But if you buy two-year Treasuries you'll get a 4.4% return."

Some investors, such as Scott Matthews, are turning to corporate bonds for the kinds of big gains that stock investors have become accustomed in recent years. Mr. Matthews, a retired businessman in Fond du Lac, Wis., has been scooping up bonds of struggling companies, such as Xerox, Polaroid and Advanta, that are trading at a deep discount to their issue price but sporting a hefty yield as a result. His gamble: As long as the companies don't default, he will score big bucks.

So far, his strategy has been working. Mr. Matthews scooped up short-term bonds from Xerox six months ago. When they matured recently, he scored a gain of 16%, or \$1,300, in just five months. A seven-month bet on bonds of Advanta recently produced a 12% return, or \$1,000. He also made almost \$10,000 in the past year buying distressed bonds of drugstore Rite Aid that were converted to shares in the company.

"I'm of the opinion that the stock market won't do much over the next couple of years, and instead of buying a stock and watch it fluctuate, I'd rather buy the bond of the same company and make 20% on my money," Mr. Matthews says. "There's some risk. If the company goes into complete default you might lose every dollar, just like with stocks."

Indeed, buying distressed bonds is at least as risky as playing the stock market. Unless a portfolio is well diversified, big losses could result if even one company defaults on its bond payments.

Then there is the issue of liquidity. Corporate bonds are traded with much less frequency than stocks, and there often is a high markup, or markdown by bond brokers. In other words, the cost to get in and

out of many corporate bonds is so high that it doesn't pay to trade these securities unless the gains are big.

Until recently, only big-shot hedge-fund and mutual-fund managers played the bond game, timing the next move by the Federal Reserve for big profit by trading bonds. Indeed, while the bond market long has dwarfed the stock market in size, it has been difficult for individual investors even to get accurate prices on bonds, let alone make a killing trading them.

Things are getting better, though. Online bond services, such as Bondpage.com, Bondagent.com and Tradebonds.com, let individuals trade bonds online, making it easier to compare prices.

In a recent comparison of various bond-trading sites, Bondpage.com was about \$100 cheaper than its rivals on a \$10,000 corporate-bond purchase. Bondpage.com executives say volume of bond transactions from individual investors has more than doubled in recent months.

Treasurys

Treasurys prices surged on optimism about interest rates and some shifting of money out of stocks to the relative safety of government securities.

At 4 p.m. EST, the 30-year Treasury bond's price was up 28/32 point, or \$8.75 per \$1,000 face value, at 101 15/32. Its yield fell to 5.277% from 5.335% Tuesday, as yields move inversely to prices.

The Dow Jones Industrial Average shed 317.34 points to end at 9973.46. Declines of that magnitude sometimes prompt investors to move money to Treasurys, and merely the anticipation of such flows of funds can lift bond prices.

Treasurys prices also drew support from a belief in the market that concerns about economic and financial trends in the U.S. and abroad will persuade the Federal Reserve to lower interest rates more aggressively than previously expected. Fed policy makers meet again Tuesday.

In Chicago, futures contracts based on the federal-funds, or overnight bank-lending rate, were trading at levels suggesting a 90% chance that the Fed will lower interest rates by 0.75 percentage point. Previously, most people in the markets expected a 0.50 percentage point drop in rates by the Fed next week.

Other catalysts for the Treasurys rally were equities downgrades and earnings warnings in Europe, as well as a credit action by Fitch, an international ratings agency. Fitch placed the ratings of 19 Japanese banks on watch, citing concern over the impact of falling share prices and lingering asset-quality problems.

Corporate and Junk Bonds

Bonds of Nextel Communications fell after the company said it expects first-quarter cash flow to fall about 15% from fourth quarter levels. Traders said Nextel 93/8% notes due 2009 and 9 1/2% notes due 2011 were bid at 86 1/4, down from 91 1/2 Tuesday.

Meanwhile, Canadian Satellite Communications postponed a \$200 million sale of seven-year notes after finding insufficient interest at the indicated yield.

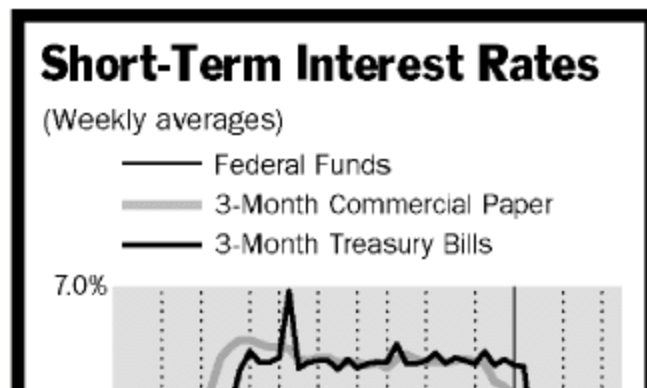
CSC Holdings Inc., a cable-TV holding company, was preparing a \$1 billion issue of 10-year senior notes, the largest junk deal in more than a month. Rated Ba-1 by Moody's Investors Service and double-B-plus by Standard & Poor's, it is expected to yield about 2.80 percentage points over comparable Treasuries. Banc of America Securities, Bear Stearns & Co. and Merrill Lynch & Co. are placing the securities privately under Rule 144a.

Chevron Phillips Chemical Co. sold \$500 million of Rule 144a debt yielding 2.25 percentage points over Treasuries, increased from \$400 million. Goldman, Sachs & Co. and Morgan Stanley Dean Witter were co-leads on the deal, rated Baa-1 by Moody's and triple-B-plus by S&P.

Ford Motor Co.'s Ford Motor Credit unit was preparing to sell from \$750 million to \$1.25 billion of three-year notes in an Internet-based Dutch auction, indicated to yield between 1.45 and 1.65 percentage points over Treasuries. HSBC Securities Inc. and W.R. Hambrecht are joint leads on the deal, rated single-A-2 by Moody's and single-A by S&P.

John Parry, Richard A. Bravo and John Dooley contributed to this article.

(See related letter: "Letters to the Editor: A Taxing Situation" -- WSJ March 28, 2001)



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