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Interest rates are rising. Here's what to do if you're investing in bonds

Inflation is high and interest rates are expected to rise this year. So what does that mean if you're investing in bonds?
You've probably heard that when rates rise, bond prices fall. And if you already own bonds either directly or through a bond fund, this is not great news.

But that shouldn't stop you from investing in bonds. And there are ways to limit the downside of a rising rate environment in your portfolio -- and position yourself to get more yield.

A few bond basics first

Forget rates for a minute.

There are two key reasons to invest in fixed-rate bonds, even though they provide lower returns over time than stocks.

The first is to buffer your portfolio against the risk and volatility of stocks. In times of stock routs and economic downturns, high-quality bonds -- especially US Treasuries -- are considered safe haven investments.

The other reason to invest in bonds is because they throw off guaranteed interest income, which is typically paid twice a year. Those interest payments are like stock dividends and can be reinvested. But unlike dividends, the interest payments on your fixed-rate bonds won't ever change.

So even when bond prices are falling, you're still getting money from your investment. "That steady stream of income, it's always positive," said certified financial planner Judith Ward, who is the senior retirement insights manager at T. Rowe Price.

So why do bond prices fall when rates rise?

A simplified way to think about why bond prices fall when rates rise is this: All else being equal, if someone could buy a 10-year bond paying 1.5% interest a year or a shorter-term bond that pays more, they likely would choose the latter.

If you happened to own that 10-year bond at 1.5% and wanted to sell it in a rising rate environment, the price would have to be low enough to attract a buyer who can otherwise get a higher yield elsewhere.

To protect your money, go shorter

The bonds most at risk of price cuts in a rising rate environment are those with longer maturities.

"The longer the maturity, the more price movement you're going to have," said David Sekera, chief US market strategist at Morningstar. "Maturity duration risk is the biggest risk to [bond] investors."

So in a rising rate environment you should consider reducing the average duration of the bonds you hold, Sekera suggested.

Based on Morningstar's estimates that the US economy will grow 3.9% this year and 3.5% next year, he thinks the current sweet spot -- the place where investors can get the best return in exchange for price risk -- are 5-year bonds both on the government side and in corporates. "That's where you're picking up the best yield for the risk you're taking on."

Between 5-year government and corporate bonds, Sekera said he thinks corporates -- which pay more because they carry higher risk than Treasuries -- are going to serve investors well. That's because he expects corporate defaults to remain low and for there to be more corporate credit upgrades than downgrades.

Should the economy not do as well as Morningstar's outlook suggests, it's likely there will be less downward price pressure on bonds because the Federal Reserve would probably slow its rate hikes and investors would look to bonds as a safe place to put their money.

Certified financial planner Clark Kendall, who runs wealth management firm Kendall Capital in Maryland, also would advise investing in shorter-duration bonds since they will mature quickly and let you reinvest the money into still higher yielding ones more regularly.

Yet, Kendall warns that regardless of rising rates, bond yields likely will not astound. So for a higher return, albeit somewhat riskier, he suggests investors might consider putting some money into dividend-paying value stocks of large, stable, companies that trade at a lower price relative to their earnings and growth potential.

Diversify your bond holdings

Another way to protect yourself in a rising rate market is to make sure your bond holdings are diversified.

T. Rowe Price's Ward recommends investing in a combination of US government bonds, high grade corporate bonds plus some high-yielding (a.k.a. "junk") bonds and bonds of other countries, including those in emerging markets. "They might be on a different trajectory in terms of rising or lowering rates, so may not be synched to the US," she said.

Within the bond portion of a retirement savings portfolio she recommends 70% be in US investment grade bonds, 10% in high yield, 10% in international and 10% in emerging markets.

In terms of your overall allocation of bonds to stocks, how much you should have depends on your age, time horizon and risk tolerance.

Generally, the younger you are, the less you should have in bonds because you want to maximize growth of your savings over time. And you have a long enough time horizon to recoup losses from the inevitable stock downturns that will occur during your career.

But the closer you are to retiring -- say five to 10 years out -- the more you'll want to have in bonds to protect your portfolio against the risk of retiring right after or right into a bear market.

You also should build up your cash reserves, Ward said, to serve as a kind of bear-market emergency fund that you can draw on for spending in your first few years of retirement, to give your stocks a chance to recover.