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Bonding With Fixed-Income ETFs

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It's no secret that investors fleeing the relentless decline in equities have crowded into the relative safety of bonds, hoping to preserve capital and grab some yield. The global flight to quality -- not to mention the Fed's zero-interest-rate policy -- has the 10-year Treasury throwing off just 2.8%. Hey, no risk, no return.

But bond mutual funds and single-issue debt aren't the only places shell-shocked investors can look to safeguard principal -- and maybe even enjoy some positive returns. For those who are so inclined, fixed-income exchange-traded funds offer cheap, liquid and transparent options, and in some cases they're actually a superior alternative to their mutual fund counterparts.

High-Grade Corporate Debt

In many ways the market for corporate debt is in a sweet spot these days. Corporations are hungry for extra cash to fund everything from acquisitions to stock buybacks, says Tom Lydon, president of Global Trends Investments and ETF Trends. The environment is also issuer-friendly, thanks to low interest rates and high demand.

If you're looking to add exposure to high-grade corporate debt, iShares iBoxx $ Investment Grade Corporate Bond fund (LQD) has a lot going for it. This ETF has $8.7 billion in assets and is highly diversified, with none of its 100 or so holdings accounting for more than 1.3% of the total pie. Perhaps most important, all its bonds, from companies like IBM (IBM) and Pepsi (PEP), are rated BBB or higher.

True, LQD is off more than 5% year to date as investors took profits out of a once-crowded trade, but then that also offers new investors a more attractive entry point. For the last three months LQD has returned 1%, while the yield stands at 5.8%.

There are a few caveats with LQD, however, as James Shelton, chief investment officer at Kanaly Trust, points out. "LQD does have about 20% exposure to banks, and that sounds a little high," Shelton says. "I'm OK with it but people should bear that in mind. And then from time to time you could pay a premium to net asset value."

Apart from those issues, Shelton sees LQD as a good way to gain broad access to investment-grade corporate credits. And at 0.15%, the expense ratio could hardly be more friendly.

High-Yield Corporate Debt

No doubt there is a case to be made for adding high-yield corporate debt (cough, junk bonds) to your portfolio, as SmartMoney's Donald Luskin has argued. But ETFs, namely the iShares iBoxx $ High Yield Corporate Bond fund (HYG), are not the way to do it.

First, here's what's good about the HYG junk bond ETF: It boasts more than $2 billion in assets, and has returned 1% the last three months. Better still, the yield tops 11%. HYG is also pretty well diversified with none of its 54 holdings accounting for more than 2.9% of the total. The 0.5% expense ratio is attractive as well.

But HYG is down 16.6% in 2009, showing any return comes with much greater risk -- and therein lies the rub.

"I don't like to use ETFs for high-yield debt because I think we are headed for a massive wave of defaults," says Shelton. "I don't think you want to own the asset class in a broad sense. If you can find a good high-yield bond manager to avoid some of the big defaults that are coming, that might make sense."

In other words, this is a case where a little active management is required to separate the solvent from the soon-to-be broke. As Kevin Mahn, portfolio manager at SmartGrowth Mutual Funds and chief investment officer at Hennion & Walsh, says: "If you are going to range into high yield, there is value in having an expert."

Treasury and Munis

Treasury debt and municipal bonds are two areas where ETFs make more sense than many of their mutual fund counterparts. "Do we really want to pay an active manager to buy a government bond or municipal bond portfolio for us?" Mahn asks. "Why not pay a lower expense ratio, get index-like returns and get that volatility dampener with a very predictable ETF?"

Treasury ETFs run across the yield curve, from the SPDR Barclays Capital 1-3 Month T-Bill (BIL) to the iShares Barclays 1-3 Year Treasury Bond (SHY) to the Vanguard Extended Duration Treasury (EDV). And for those betting on the galloping return of inflation, there's the iShares Barclays TIPS Bond (TIP), among other products.

But Treasury ETFs are a simpler matter than municipal bond ETFs, where the risk of default is a very high concern.

The key is to stick to high-quality, general obligation bonds because the default rates are extremely low and the federal government may even purchase muni debt in the future, Shelton says. It's also a good idea to stick to shorter, rather than longer maturities, such as iShares S&P Short Term National Municipal Bond Fund (SUB).

"For investors who are looking to step out just a little bit on the yield curve from cash, I think SUB is a good choice," Shelton says. "Holdings have a duration of about two years and it yields about 2%, tax free."

As for longer-term munis? Treat them like junk bonds and pay a little extra for active, expert management.