Building a Fed-resistant portfolio

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Summary: There are good reasons to fear the Federal Reserve. Bond funds could see big losses if interest rates rise quickly. Historically, both stocks and bonds posted lousy five-year returns when rates were rising; they do best when high rates were falling.
However, Fed researchers say “QE 3” had only a modest influence on rates. Since 1995, the 10-year Treasury has averaged right around GDP growth, which has ranged from 3% to 3.5% lately. So rates might not rise for years, and then only slowly.
But enough about optimism. Here are strategies for three scenarios, in order of probability.

Rates rise slowly:
Sit tight and stick with your long-term strategy. This is a good time to rebalance out of stocks into short-duration bonds; Ben Graham would shift toward 40% stocks and 60% bonds.
Don’t be afraid of good bond funds; income should make up for NAV losses over time. Keep your bond ladder and look for opportunities to raise yields as individual bonds hit their terms.
Brace for stock market volatility. Find good value stocks with wide moats and keep them forever. If you don’t pick stocks, keep dollar-cost averaging into super-low-cost index funds or ETFs. Keep enough cash to buy into every correction.

Rates rise quickly:
Harvest stock gains and raise liquidity, either in cash or very short-duration bonds. If you’re rich, holding a bond ladder is better than bond funds, even if it has just two rungs. Talk to an adviser about “barbells.” Stay away from bond alternatives.
Stock bargains are getting hard to find, so lower expectations and ride out volatility. Take advantage of corrections (index drops of 10 percent or more) to buy index funds or value funds.
Remember that markets misprice bonds, too. High yield munis and corporates could do well, if a skilled manager finds bargains.

Rates don’t rise at all, ala Japan:
Yet another scenario that favors great stocks for the long run. The income-starved may consider MLPs or REITs (if they have little debt) that have oversold. Deep value stocks in emerging markets could go on sale this year, but only if you find a good fund manager that picks companies focused on internal demand, and not exports or raw materials.
Bond funds won’t make much money, but will serve the purpose of portfolio stability. Floating rate bank loans and other alternatives are risky, but have reasonable yield prospects.

See the reverse side for fund examples and other resources. Note: I haven’t researched some of these funds, so I don’t recommend them specifically. The list is to provide ideas for further exploration.

Stocks:

As always, talented value managers beat other strategies, so buy their funds in corrections. Because such managers are hard to find, most investors should stick to low-cost index funds, using dollar-cost averaging to make investments and disciplined rebalancing as stocks change in values compared to bonds.
(BRK.A or B) Buy Buffett in a big correction; (WPVLX) Weitz Partners Value; (ARTLX) Artisan Value; Joel Greenblatt's Long/Short fund (GENIX)

Low-cost sectors:
(VDE) Vanguard Energy ETF; (VCR) Vanguard Consumer Discretionary ETF; (XLF) Financial Select Sector SPDR

Stock-bond buy and hold mixes, with barbelled bonds:
(VWELX) Vanguard Wellington (two parts stocks, one part bonds); (VWINX) Vanguard Wellesley (one part stocks, two parts bonds)

Bond funds:
(DODIX) Dodge & Cox Income; (VFSTX) Vanguard short investment grade; (VCSH) Vanguard's short index ETF; (HYG) iShares high yield corporate (yields 7%)
Worried about funds' NAV risk? This bond ETF family acts like bonds with short durations: Guggenheim Bulletshares; (BSCG) is the 2016 term

REITs (wait for healthy discounts to NAV, if possible):
(O) Realty Income, based in Escondido; (VNQ) Vanguard REIT ETF; (IYR) iShares REIT ETF; (HT) Hersha Hospitality; (AEC) Associated Estates; (CWH) CommonWealth

Floating Rate Bank Loans:
(FFRHX) Fidelity Floating High Income; (EVBLX) Eaton Vance Floating

Further reading:

Buy Treasuries with no commission: http://www.treasurydirect.gov/

www.morningstar.com and ETF Database: http://etfdb.com/etfs/

Bernanke on why interest rates are so low: http://utsd.us/1nsehB6

How banks create money out of loans: http://utsd.us/1aLbIr7

Shiller CAPE ratio for individual stocks: http://www.caperatio.com/

All the economic data you ever need: http://research.stlouisfed.org/fred2/