Bond Fund Investment

Consideration of Key Factors

Introduction

"A rising tide lifts all boats" is an adage that is often applied to investment performance. It is particularly true in the relationship between bonds and bond mutual funds. Over the most recent period of declining interest rates, investors in both products achieved consistent income and rising principal values. But as the prospects for rising interest rates grows, it is valuable to understand some key differences between holding individual issues of bonds versus owning fractional shares of a bond mutual fund.

Advantages of Bond Funds

As a backdrop to the discussion, whether an investor elects to hold individual bonds or bond mutual funds in his or her portfolio depends in large part upon each client's amount of investable assets. Diversification, particularly in corporate and municipal securities, is a critical element of portfolio construction. Because mutual funds pool their assets, they are able to achieve greater diversification among issuers, maturities, credit quality and bond structure than individual investors can achieve buying individual issues, unless they have sufficient investable assets. Generally speaking, an investor with investable assets of $5 million can achieve sufficient diversification owning individual bonds. Investors with somewhat smaller sums may also be able to achieve

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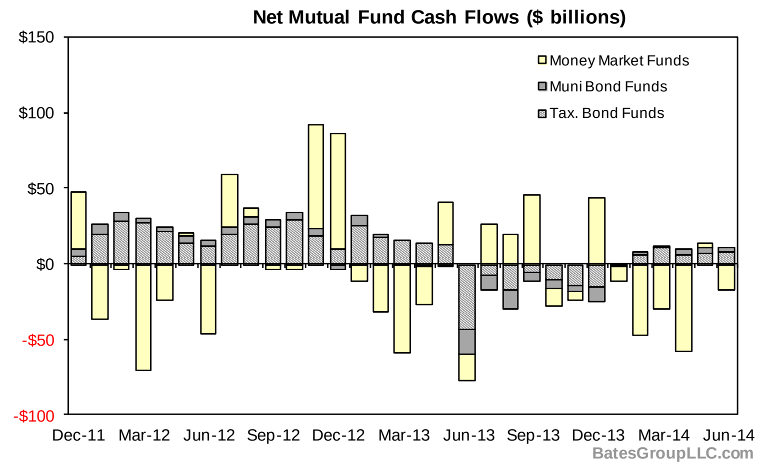
sufficient diversification by concentrating exclusively in bonds with higher credit quality. Many investors may find that they are unable to achieve appropriate levels of diversification outside of the mutual fund vehicle.

In addition, because mutual fund managers buy and sell large amounts of issues, they are capable of achieving price efficiencies beyond what many individual investors can, unless they have sizeable assets to invest. Because mutual fund managers buy and sell "block" sums (usually in excess of $1 million) of issues at one time, they are capable of price efficiencies most individual investors would not be able to capture acting solely for their own account. The differences in purchase price can add to the realized return on investment over the lifetime of the account.

Another important element investors must consider in choosing between bonds and bond funds is their ability to make educated investment decisions themselves or through access to professional advice. Being able to understand the creditworthiness of corporate and municipal bond issuers as well as bond structures and covenants is important to the success of the portfolio in up and down markets. Investors today have greater access to bond research and bond inventories than ever before. Investors also have greater price transparency, allowing them to buy and sell at lower costs than has historically been the case. But, despite the greater availability of information for self analysis, investors may still prefer to defer to an expert in making bond investment decisions, something that they can get access to through the vehicle of a bond mutual fund.

Many investors are choosing to put their money into bond funds, according to information provided by the Investment Company Institute. From December of 2011 through June of 2014, investors added $281 billion to their bond fund holdings (see chart below). However, there are some issues these investors should be aware of in comparing the performance of these holdings to the performance of bonds themselves in rising rate environments, discussed below.



Disadvantages of Bond Funds

Bond mutual funds have some inherent disadvantages to individual bond portfolios which become most apparent when interest rates rise. Bond prices and yields are inversely related; thus, when interest rates decline, the price of bonds rises. Conversely, when rates rise, bond prices will decline. As interest rates rise, the value of the bonds in a portfolio or mutual fund will decline in value. For investors in individual bonds who can hold their bonds to maturity or until called, this may not present a problem. Because the investor will continue to earn the coupon rate of interest typically paid to the investor semi-annually, his income stream remains constant. If the investor holds each bond until maturity or call, his principal invested remains intact.

However, if the investor needs to sell a bond before maturity or call, and the market price of that bond has declined below the price at which it was purchased, the investor will sustain a principal loss which will negatively impact the investor’s investment rate of return for the holding period of that bond. But bond mutual funds cannot escape the impact of rising interest rates.

As fund managers liquidate bond holdings either to fund redemptions or raise cash in anticipation of higher rates or rising redemptions, they are selling bonds that were purchased when prices were higher. As those assets, as well as new assets from coupon payments, get reinvested in new, lower-yielding bonds or money market funds, the fund’s yield is reduced.

Bond funds will generate principal losses in more pronounced or extended rising interest rate environments. While individual issues of bonds mature or may be called, bond funds never mature. The only way an investor can get principal returned is by redeeming some or all of their mutual fund shares. When investors redeem shares, the fund must liquidate holdings of bonds it owns. When market values are below the acquisition cost of those bonds, the fund realizes a principal loss.

Anytime any investor in the fund redeems shares, it creates a principal loss, which in turn reduces the value per share of the fund, which impacts all investors in the fund, who may find themselves in a "run on the fund" scenario. As redemptions rise and the fund liquidates its bond holdings, selling pressure lowers the market value of all bonds in the market as supply begins to overwhelm demand. Since bond funds must value their holdings daily based upon current market value, declining bond values reduce the value of holdings by the fund as unrealized gains are reduced and unrealized losses grow.

Realizing principal losses also lowers the monthly dividend the fund can pay, which reduces investor’s current income. Many bond fund investors invest based on the level of income bond funds can provide at the time. But with realized losses and declining share value, fund managers will be forced to cut dividends.

How much rising bond yields will affect the market value and dividend rate of a fund is dependent upon two factors: the duration of the particular bond fund and the percentage change in bond yields. In broad terms, duration is a measure of a bond’s price sensitivity to a change in interest rates. Most bond funds have duration targets or target ranges which vary between short term, intermediate term and long term bond funds. Because long term bond funds have greater durations than short term bond funds, rising interest rates generally will affect the performance of long term funds more. An investor who held $1 million worth of shares in a bond mutual fund that had an average effective duration of 10 years would experience a drop in fund value of $100,000 if yields rose 1 percentage point.

Finally, rising interest rates can create an unwanted tax situation for municipal bond fund investors. As bond funds sell bond holdings either in anticipation of or in response to rising interest rates, they most likely are selling holdings they bought when interest rates were higher. These bonds, which have appreciated in value, generate capital gains for each fund investor. Bond fund managers typically avoid taking capital gains unless they can be offset by capital losses to reduce the negative tax consequences. But accomplishing that becomes more difficult, particularly in the early stages of a rising rate cycle, as most holdings have unrealized gains.

Conclusion

When evaluating whether to invest in bonds or bond funds there is no right answer. One is not necessarily better than the other but both offer distinct advantages and disadvantages. Each investor together with their financial advisor must assess their particular situation to determine whether individual bonds or mutual funds are most appropriate for their particular circumstances.

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