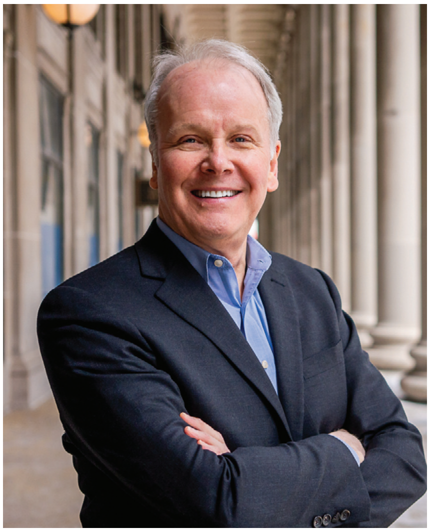

Bonds vs. Bond Funds: Which Reigns Supreme?

Bonds play an important role in any well-diversified investment portfolio. But when it comes to buying individual bonds or bond funds, is one stronger than the other?

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Financial planners, money managers, and do-it-yourself investors all face the question of whether to employ funds or individual securities in the investment portfolios they manage or oversee. Generally, I believe funds—whether open-ended mutual funds or exchange-traded funds (ETFs)—do a pretty good job of replicating individual securities. For example, the performance and risk characteristics of low-cost stock mutual funds reasonably mimic portfolios of individually managed stocks with the same characteristics.

However, there's one area in the investment landscape where I believe this observation falls flat: bonds. Because of the nature of a bond, bond funds fail to replicate important characteristics of a portfolio of individually managed bonds. This is why I believe a portfolio of individual bonds is superior to bond funds. Why? Let's consider a bond's purpose in a well-diversified investment portfolio.

A bond is essentially an IOU issued by a corporation, government, or other entity. In exchange for the investor's or lender's money, the issuer of the bond generally makes two promises: 1) to repay the funds at some date in the future, and 2) to pay interest periodically over the period leading up to the principal repayment date. For example, interest might be paid on April 1 and Oct. 1 for 10 years on a bond that was issued on April 1, 2023, with a maturity date of April 1, 2033.

From an investor's point of view, a bond is inherently less risky than a stock because bondholders will be repaid their invested capital at the maturity date. Similarly, the bond issuer promises to pay interest income per the terms of the bond indenture, providing the bondholder guaranteed income for the duration of their holding period. When investing in a share of stock, however, there's no promise of repayment. Income from stock—or dividends—is expected to be paid but isn't generally guaranteed (except in the case of preferred stock) and can also fluctuate based on the company's earnings or other factors. Therefore, the benefits of holding bonds are that these promised features reduce the inherent price volatility in these investments and offset, to some degree, the greater volatility of stocks and ultimately help smooth out valuations in a well-diversified investment portfolio.

Of course, as we all know, there's no free lunch in investing. The cost of the guarantees bonds provide is, generally, a lower overall expected return than that of stocks. Further, not all the guarantees bonds promise are rock solid. There's always the risk that bond issuers may default on interest and/or principal repayments or declare bankruptcy. In those cases, bondholders may receive less than 100 cents on each dollar invested. Though, they still might make out better than stockholders who often see far less for their investment if the stock issuer becomes insolvent.

Limiting these risks are the primary benefit of investing in a bond fund. Unfortunately, little can be done about increasing expected returns except by investing in either longer-maturity bonds or higher-risk issue bonds that typically yield higher interest rates. However, individual issuer default risk can be reduced through holding a bond fund since the fund likely holds hundreds of bonds. As such, the impact of any issuer going into default is almost certainly lower in the bond fund than in a portfolio holding fewer individual bonds.

The risk of default is certainly a powerful motivator for financial advisors and portfolio managers to consider when implementing fixed income exposure through bond funds rather than individual bonds. But default risk is a risk that can be managed (although not eliminated). For example, municipal bonds often carry insurance provided by third parties who stand ready to pay bondholders if issuers can't or won't do so. Non-insured bonds—primarily corporate bonds—are regularly reviewed by third parties who issue credit quality ratings for bondholders and advisers alike to determine if action should be taken. Admittedly, many, but not all, bond defaults take place after warning signals appear.

Still, I believe the construction of a typical open-end bond mutual fund or ETF simply can't compete with two key features of a portfolio of individual bonds. Those key feature include:

1. **A higher predictability of return:** Because the holdings in a bond fund change regularly as issues mature or are called in early by the issuer, and proceeds from these activities are used to purchase new bonds, the investment return also varies. A portfolio of individual bonds, however, has fewer turnover events. For individual bonds, the return is much more predictable because the bonds pay the stated coupon rate generally for the life of the bond. This certainty of returns can be especially useful when investing to a target income level, such as with the case of retirees.

2. **Less risk as the bond matures:** Most bond funds maintain a relatively consistent average maturity over time, which can be helpful for understanding how to compare funds as average maturity directly impacts pricing. However, this ignores the benefits that come each day from approaching an individual bond's maturity date. After all, the closer to maturity date, the less risky the bond is and the more likely the bondholder will be repaid their principal. And of course, the individual bond investor enjoys knowing that their bond portfolio risk is lessened as time goes on because the maturity date of each bond draws closer.

Case in point, individual bonds are generally superior to bond funds because they take advantage of the inherently lower volatility features of bonds over stocks and provide more predictable income. Though, admittedly, buying individual bonds is more problematic than buying bond funds. Why? Because the cost of purchasing a bond is built into the spread between bid and ask prices. That spread is higher and more costly when buying bonds of smaller amounts (e.g., $1,000 or $5,000) than greater amounts. And once you diversify a portfolio (e.g., investment company Charles Schwab recommends holding bonds from no less than 10 different issuers), one can see that purchasing individual bonds make sense only in larger investment portfolios.

A solution to this challenge is to invest in so-called defined maturity date funds. These ETFs invest in bond issues with a single maturity date. The funds provide diversification among issuers, as well as the benefits that come from shortening maturities. At the end of the maturity date year, the fund dissolves and all cash is returned to shareholders. For reference, investment management company Invesco Ltd. markets a number of these funds under its BulletShares brand.

Overall, bonds will always hold a place of importance in most investment portfolios because of their lower volatility and higher predictability of total return compared to stock investments. Though, how an investor chooses to implement the addition of bonds to a portfolio—whether it be from individual securities or bond funds—needs to be driven by that investor's goals and financial position. Ultimately, for investors small and large, I still believe individual bonds or defined maturity date bond funds are far superior options over generic open-ended bond mutual funds and ETFs.