

Dispelling individual bond myths

Many investors will buy mutual funds for the common stock portion of their portfolio but prefer individual bonds for the fixed income portion. They believe there is safety in the promise that a bond will eventually mature for a known amount and mutual fund expenses are too high for a low return asset like a bond. The truth is that the known maturity does not provide the safety it seems to, there are many low cost bond mutual funds, and bond mutual funds add significant safety through diversification.

Individual Bonds are No Safer

The first assertion commonly made by advocates of individual bonds is that you cannot lose money if you hold the bond to maturity. This, of course, assumes there is no default and implies the interest rate risk inherent in all bonds is avoided by holding a bond to maturity. There is an inverse relationship between bond prices and interest rates. When interest rates go up, bond prices go down and vice versa. A 10-year bond yielding 4 percent will lose 8 percent of its value if interest rates rise to 5 percent and its value will drop 15 percent if interest rates rise to 6 percent. The argument for individual bonds is that you will get 100 percent of the face value of the bond if you hold it to maturity. This is true, but is it advantageous?

Holding a bond to maturity to avoid the loss resulting from rising interest rates does not avoid the loss. Holding a bond paying below market interest is just a different way to take the loss. All one achieves by holding the bond is to take a capital loss and spread it over the remaining life of the bond in the form of lower interest payments. As soon as interest rates move, the loss has occurred. The investor's only decision is whether he would like to take the loss in lower interest payments over time or as an immediate capital loss.

Most Bond Mutual Funds are Too Expensive, But Not All

The second claim made by advocates of individual bonds is that bond mutual funds are too expensive. This is an accurate complaint against most bond mutual funds. The average bond mutual fund in the Morningstar® database has an expense ratio of 1.10 percent and a front-end sales charge of 1.13 percent. It makes no sense to buy a bond mutual fund with expenses like that. It is this type of mutual fund that gives rise to the popular belief that bonds should be purchased outright, not in a bond mutual fund. However, there are 176 no-load bond mutual funds in the Morningstar® database with annual expenses of less than 0.40 percent and 85 with expenses of 0.25 percent or less. These funds cannot be dismissed so easily.

Institutional Bond Investors Get a Better Deal

Moreover, institutional investors, like a mutual fund company, enjoy much more favorable bond pricing. They buy for less and sell for more than retail bond investors. The bond market does not work like the stock market. Not everybody gets the same price. The bond market is made up of dealers. These dealers buy and sell bonds like used car dealers buy and sell cars. They try to buy for as little as possible and sell for as much as they can. What they will pay for a bond depends on what they think they can sell it for.

A dealer may be willing to pay a fair price for a \$1 million dollar round lot position for which he knows he has a buyer. On the other hand, a \$100,000 position is generally considered an odd lot. A dealer is not going to be very interested in such a small position and will price it higher if selling to an investor or lower if buying from an investor.

There has been so much abuse in tax-exempt bond pricing that a website (www.municipalbonds.com) has been created to disclose aggregious trades and help investors evaluate the fairness of their own trades. Knowledgeable traders dealing in large volume can really earn their keep in the bond market. Overall, trading bonds is difficult and expensive for retail investors and it takes a very large portfolio to enjoy institutional pricing.

Further complicating matters is the fact that brokers commonly price their commission into bonds. This makes it difficult to determine what you are truly paying for the bond and what you are paying in commission. Sometimes brokers bypass the dealer and buy and sell bonds in their own inventory. In that case the broker may not even know what commission they are charging. It is all blended together.

Bond Mutual Funds Provide Diversification and Ease of Management

The two principal advantages cited by advocates of individual bonds are not as compelling on closer inspection as they seem at first glance. Holding a bond to maturity does not really protect investors from the loss resulting from interest rate movements and there are many low cost bond mutual funds in which some or all of the cost can be offset by the institutional pricing. So far we have dispelled the myths that individual bonds are safer and lower cost than bond mutual funds, now we will describe the advantages of bond mutual funds that make them the better alternative for most individual investors.

For most investors, the most important advantage of a bond mutual fund is diversification. While a \$2 million portfolio of bonds might own 8 or 10 individual bonds, a bond mutual fund will own hundreds if not thousands of different bonds. This means any individual default will have minimal impact on the portfolio. This is not important for Treasury Bond investors, but investors looking for the higher yields of corporate bonds or the tax benefits of tax-exempt bonds will benefit by this greater diversification.

There are also trading strategies that are advantageous to bond investors. For example, the last year before a bond matures is usually the lowest return year. Institutional investors can increase returns by selling a bond before it matures. Retail investors will decrease returns by selling a bond before it matures because of higher trading costs. This and other trading strategies are not management strategies that depend on a forecast of interest rates or other unknown future event. These are trading strategies that work based on the structure of interest rates and the shape of the yield curve.

A final advantage is that bond funds are much more liquid. While the value of a bond fund will fluctuate with the market, a bond fund can be completely liquidated at institutional pricing at any time. This is very important to many investors. This allows easy cost-

effective portfolio rebalancing. Moreover, bonds are often the safest portion of a portfolio. Therefore, investors will look to the bond portion of their portfolio first to meet a surprise cash need. In addition, many investors for whom tax-exempt bonds were appropriate during their working years will find taxable bonds better when they retire. They may want to convert their entire portfolio from municipal to taxable bonds on January 1 of the year their taxable income drops. Doing so would be prohibitively expensive for a portfolio of individual bonds, but very inexpensive for a portfolio of bond mutual funds.

Bond Mutual Funds are Better for Most Investors

In summary, fixed income portfolios of less than \$10 million should almost certainly be invested in bond mutual funds. Above \$10 million the merits of bond mutual funds versus individual bonds is open for debate - although even above \$100 million, bond mutual funds have some benefits over individual bonds. There are 362 bond mutual funds in the Morningstar® database with minimums in excess of \$10 million, one of which has a minimum of \$250 million. This is evidence that there are many bond investors investing significant sums in bond mutual funds.