ADVISOR PERSPECTIVES

# Buy Bonds and Not Bond Funds

By Hildy and Stan Richelson
November 24, 2009

*Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.*

The marketing claims of the mutual fund industry assert that bond funds are superior to individual bonds because they provide total return that includes income as well as capital appreciation. By adding bond funds to a diversified portfolio, academic studies claim that an investor's risk is lowered to his or her risk tolerance.

Record inflows into longer-term bond funds in the last six months have provided investors purported relief from the near-zero returns in money market funds. While those inflows have contributed to market dislocations, helping drive municipal bond yields to record lows, do not mistake those inflows or rising prices for an endorsement of bond funds.

Bond funds are inferior to individual bonds, as those who are now buying bond funds may soon discover.

It is not possible to know the exact return you will receive on a bond fund because that return depends not only on future interest rates, but also on the characteristics of the fund – its expense ratio, trading costs, maturity and credit positioning, and its diversification. With an individual bond, you are at least assured of a specific cash flow if held to maturity and the return of your principal. The total return depends on the periodic reinvestment rate of the interest payments.

You need a less diversified portfolio if you invest in high-quality bonds. Go for quality, not quantity.

Bond funds do not have the same characteristics as individual bonds. Individual bonds pay the same amount of interest every six months through maturity, at which point they pay the face amount of the bond. If you hold individual bonds to maturity, you do not have to bet on the direction of interest rates because you will get back the face amount of the bonds when the bonds come due. You can also choose the quality of the bonds you purchase. If you decide to sell an individual bond before its due date, you may get more or less than you originally paid, depending on the level of interest rates at that time.

**Understanding bond funds is more challenging than understanding individual bonds**

Buying an individual bond is straightforward. The only cost you incur is embedded in the bid-ask spread, unless you purchase the bond through a broker who charges a commission. No other fees are incurred unless the bond is sold prior to maturity.

By contrast, bond fund investors face a myriad of embedded costs and understanding those costs is a challenge. The fund may charge a one-time fee for purchasing or exiting the fund in addition to ongoing management, maintenance and administrative fees paid out to the funds' investment advisor. There may be distribution or service (12b-1) fees. Funds also incur trading costs based on their turnover, which are not reflected in the expense ratio and are not usually reported. Funds may also impose a low balance fee if the account is below a specified amount. The 'other expenses' category includes custodial, legal and accounting fees, as well as securities transfer fees and other administrative expenses. The fund's expense ratio that reflects most of these fees is usually fixed, so an investor can assume that the fund will annually take that percentage of the assets.

In order to cover its fees and expenses, funds must invest in lower grade (riskier) bonds to stay competitive, while you may prefer a higher quality portfolio. Instead, you can lock in high yields and purchase high quality bonds when you build your own portfolio of individual bonds.

If you are seeking a fund with good quality bonds, be sure to review the fund's holdings, paying close attention to illiquid bonds and lower quality bonds. Only recently, auction rate preferred securities and collateralized debt obligations revealed how complex and confusing debt can be. Unwitting investors may choose a bond fund because its yield is higher than a fund holding higher quality bonds. This may turn out to be a costly mistake in many market conditions, as lower quality bonds are more volatile and more likely to default.

A fund generally is mandated to stay at least 95% invested in a class of bonds as set forth in its prospectus. It must purchase its mandated bonds even if the fund's management doesn't deem them attractively priced and they would rather stay in cash. A purchaser of individual bonds has the option to wait. They sometimes wait in bond funds, creating volatility in the fund by exiting once they view opportunities to purchase individual bonds or other investments to be attractive.

If you buy shares of a fund when a fund has declared but not yet distributed income or capital gains, you will be "buying a dividend." You pay the full price for the fund and then receive a portion of the price back as a dividend, which is a potentially taxable distribution.

**Passive bond funds are still bond funds**

You may think that you can avoid all this complexity by avoiding actively managed bond funds, but passive funds are still considerably more complex than individual bonds. Some passive funds claim that they mirror an index, but it is often difficult for a fund to obtain all the bonds in the index or to obtain those bonds at the same price as is used in the index. In addition, the bond funds may use derivatives. As a result, these funds have tracking errors.

Exchange Traded Funds (ETFs) are repriced all through the day. But the bond market is incredibly illiquid – especially when compared to the stock market – and most bonds do not trade on a given day. As a result, bond ETFs are priced using mathematical algorithms, which may resulting in pricing that diverges significantly from actual market conditions. This is defined as the tracking error. When you buy a bond ETF, you may be paying a lot more or less than the ETF is actually worth.

**The mystery of leverage adds to investor risk**

Some funds are leveraged (use borrowed money) and are therefore more volatile. The fund manager decides how much leverage to use at any given time. The funds call this "professional management." The PIMCO Total Return Fund has achieved great success using this strategy, but what is inside the fund is unclear. According to Business Week's Lewis Braham (see here), the fund counts as cash what Morningstar calls bonds. PIMCO looks at the duration of the bonds, while Morningstar looks at maturities when defining cash equivalents. An assortment of convertible bonds, preferred shares or derivatives can be in the "Other" category. Braham says what is in the fund is "tough to figure out." In times of good performance, neither investment advisors nor individual investors seem to care.

Individual bonds are levered only if they are purchased in a margin account, which is under the complete control of the investor. As we point out in our book, *Bonds: The Unbeaten Path to Secure Investment Growth, (Bloomberg Press, 2007)* if you match your assets (bonds) to your liabilities (anticipated expenses), you don't have to rely on positive performance. It is hard to remember that higher risk often means losses, not just higher returns.

**Fund yields and returns can be deceiving**

Selecting a bond fund is complex because there are numerous reported yields and returns. This divergent information is not easily reconciled and it is easy to be misled. For example, there are on-going management fees, other fees, expenses, and spreads on the sale and purchase of bonds that may be included in one metric but not another.

To earn the stated yield-to-maturity for a fund when you purchase it, you would have to hold the fund until all the bonds matured, interest rates would have to stay the same and, most importantly, the fund manager would need to keep the portfolio unchanged. The second and third assumptions are never true; interest rates change and managers trade their portfolios. (Even target date funds, which are designed to be a safe investment that liquidates at a specific date, still trade the bond portions of their portfolio.) Investors, even if they diligently hold a fund to maturity, have no way to know what return to expect.

Understanding a fund's actual return is very difficult. Funds report total return numbers. Yet total return is not an accurate basis of comparison for one fund to another, since they may have different risk levels and, therefore, should be measured against different benchmarks.

The 30-day SEC yield gives you a way to compare one fund to another. It is a backward-looking measure, based on the yield-to-maturity of a fund's investments over the prior 30-day period. As new securities are acquired, this yield changes daily. This yield does not reflect the dividends paid by a fund; a fund with a high 30-day SEC yield may not pay high dividends. It does not necessarily reflect the yield an investor would get at the time of purchase. Though the fine print says don't use past performance to judge future performance, it is hard not to drink the Kool-Aid because the information presented is so appealing, simple and authoritative.

Since we all want to be in the best performing funds, our tendency is to purchase the fund with the best performance figures. Since the yield data provided is backward looking, the usual result is that we buy at the top and sell once the yield declines. This is the classic buy high, sell low. This is why investor returns are consistently lower than the funds' internal rates of return.

The bottom line is that the assortment of possible returns listed for funds is very confusing. There are too many possibilities even for a sophisticated investor.

When you buy an individual bond, you know the yield-to-maturity and the yield-to-call going forward, and the rate of return based on an assumed reinvestment of coupons. You won't know what the exact outcome will be, but you have a more realistic idea than if you bought a bond fund.

**Funds that appear attractive may not be**

Individual bond investors can select premium or discount bonds based on prevailing market conditions and their personal tax situations, but bond fund investors will own whatever bonds the fund owns, often with adverse consequences.

Many funds routinely purchase premium bonds (selling for more than their face value) as a way of increasing cash flow and dividends paid to investors. However, this will ultimately erode the value of the fund because the premium will amortize (decrease) to par over time. Fund investors may be subject to adverse tax consequences insofar as some of the return of principal on premium bonds may be subject to,state income tax. Similarly, if the fund buys deep discount bonds this might result in adverse federal income tax consequences.

Investors in municipal funds face additional complexities. They may choose a tax-free bond fund for federal tax-free income. However, all or a portion of the fund's dividends may be subject to the alternative minimum tax (AMT) if there are AMT bonds in the fund. If you are subject to the AMT you would not want to purchase a fund with AMT bonds. You must check the prospectus and semi-annual reports to determine what percent of the bonds are subject to the AMT. Some bond funds have a higher return because they own a large amount of their portfolio in bonds subject to the AMT. However, if you are subject to the AMT you may have a substantially lower return on an after-tax basis.

When purchasing individual bonds you can choose whether or not to purchase AMT bonds. Bonds subject to the AMT have both a public and private purpose, and generally are considered weaker credits than general obligation and essential service revenue bonds.

Remember that mutual fund returns are not adjusted for taxes. You are responsible for discovering how Uncle Sam will view the fund's payout as it affects your personal tax situation.

**Duration: understanding the riskiness of bonds**

The duration of a fund or a bond tells how much the price will change with a shift in interest rates. For example, a long-term muni fund with an eight-year duration will drop eight percent if interest rates rise one percent, all else being equal.

By purchasing bond funds, you are making a bet that interest rates will either stay the same or decline *and* that you can time the market turn if interest rates were to rise significantly. If your bet is wrong, you may lose eight or more percent if interest rates move up one percent.

Though individual bonds may have the same market volatility as bond funds, as they approach maturity their price will move closer to their face value and its volatility (duration) will decrease. You can ride out the volatility with individual bonds.

**Park your money in a bond fund at your own risk**

Many investors view bond funds as a more liquid investment than individual bonds. They believe they can invest in a bond fund to get a higher return than on individual bonds and nimbly exit before interest rates rise and the price of the fund declines. This is often more a hope than a result.

Buying and selling fund shares may generate income taxes, fees and expenses. If you decide to purchase an individual bond, you might give the transaction more thought. It is like purchasing something with a credit card or for cash. Just because the credit card is easier it is not necessarily better for your financial wellbeing.

Some view longer term funds as a convenient parking place for funds when money market funds pay close to zero interest and they are not ready to invest for the longer term. The outcome of this approach might not produce the intended results.

For example, assume you invested $1,000,000 in a municipal tax-exempt bond fund on September 17th, 2009 at a price of 12.96 per share, as a holding place until interest rates were sufficiently high to warrant a long term investment in bonds.

On November 10, 2009 you re-evaluate your position. The fund was then valued at 12.75 for a principal value of $983,796. The initial investment had fallen, resulting in a paper loss of $16,204 minus $4,555 interest credited to your account. Your loss is $11,649 if you sold on the re-evaluation date. That is a loss of 1.16% or an annualized rate of about 9.28%.

By investing in this fund for seeming liquidity and a higher interest rate than a money market fund, you place a bet that interest rates will decline. As you can see, that bet may not be offset by the higher return in a long-term fund.

**A few ideas for individual bonds**

Here are just a few ideas for those thinking about buying individual bonds:

Search for Bargains: While the two-year Treasury note is yielding 0.72% (11/20/2009), a two-year certificate of deposit (CD) insured by the FDIC might yield 2.33%. If you do not need short-term liquidity in your portfolio, you could lock in almost 5% on long-term Federal Agency bonds.

Build America Bonds (BABs) are a new class of taxable municipal bonds that are supported by a 35% credit from the Federal government to the issuer. They have proved very popular.

Compare primary to secondary market offerings: The primary market represents the going rate for institutions that are purchasing large blocks of bonds and are most immediately affected by a rise in bond prices. The disparities between the primary and secondary markets are often striking.

Buy Kicker Bonds: When interest rates are falling, the place to look for good yields is in the secondary bond market. "Kicker bonds" are previously issued bonds that have a:

- higher coupon than the going rate,
- decent yield to the call date, and
- chance of yielding much more than the going rate if they are not called prior to maturity. They may "kick" to a higher return.

For example, on April 1st 2009, a previously issued Cornell University bond with a 5% coupon rated double-A was offered to yield 4% to the call date in 2016 and 4.6% to maturity in 2024. By comparison, a new issue Malden City, MA, an insured triple-A bond with a 4% coupon yielded about the same to the 3-year longer call date in 2019 (4.09%), but not much more to maturity in 2024 (4.08%). If you buy a kicker bond you give up some call protection in exchange for a higher coupon and the possibility that you will earn a higher return to maturity if the bonds are not called. Even if the bonds are called, you still will do well if the yield to the call is adequate.

Purchase Protection from Inflation: United States Treasury Inflation Protected (TIPS) bonds provide a small coupon and a current cash flow that is generally less than traditional Treasury bonds with the same maturity. However, if there is inflation as measured by the consumer price index (CPI-U), the face value of the TIPS will increase by the increase in the CPI-U, and the effective coupon rate will increase to keep pace with inflation. Purchase these bonds in anticipation of inflation. They will be very expensive when inflation is surging.

*Hildy Richelson and Stan Richelson are bond advisors who focus their practice on the design and management of bond portfolios for high-net-worth individuals. Hildy is President of Scarsdale Investment Group, Ltd., a fee-based advisory firm in Blue Bell, PA. Hildy and Stan are authors of the award winning book entitled, Bonds: The Unbeaten Path to Secure Investment Growth (Bloomberg Press, 2007).*