Bond Investing and Fear of Inflation May 15, 2012. Hildy Richelson and Stan Richelson

Bond Funds for Investors in 401(k) style plans

Investors in 401(k)s, unfortunately, cannot invest in individual bonds. They are given the alternative of investing in bond funds, which are really quasi stock investments because the bond funds never come due. Having a fixed maturity date is the key feature of an individual bond because on that date you know that the principal will be returned and you will get back the face value of the bond. Bond funds can only return to you the price of the day, which may be more or less than you initially invested. The bonds in the funds do pay interest regularly, which cushions the movement of the price fluctuations.

Bond funds have benefited from declining interest rates which have pushed interest rates down. To give you an idea of how low it is, the average yield to maturity of *The Bond Buyer* municipal bond index, which is based on 40 long-term bond prices, posted a yield of 4.48 percent in the second week of May 2012. The index, which began in July 1984, never posted a lower weekly average for the yield to maturity.[i] The falling yields and rising prices of funds has attracted large cash inflows from individual investors.

Bond funds have been avid purchasers of premium bonds, which enhances their dividend payouts, along with bond sales that might generate capital gains. Since short-term bond yields are so low, funds have been flowing into intermediate and long-term bond funds. At the end of 2011, the 10-year triple-A municipal bond yielded 1.83 percent and overall bond mutual funds were up 10.7 percent.[ii] Assets continue to flood into bond funds.

While you might expect an increase in price of individual municipal bonds to be reflected in the prices of the funds, this is not always the case. In the second week of May 2012, the 30- year tax exempt yield hit a new low, and the 10-year approached its low. According to *The Bond Buyer,* "iShares S&P National AMT-Free Municipal Bond ETF (ticker MUB) fell .88 percent on Monday, as well as the SPDR Nuveen Barclays capital short Term Municipal bond ETF (ticker SHM), which fell 0.08%"[iii] in the same time frame. So the advice bond fund buyers is that you must "look under the hood" of the muni fund to find out what kinds of bonds it is holding, the names of those bonds and what the credit quality is. Are there any other features of the fund, like fees of any sort, of which you need to be aware? Is the price just a function of the value of the bonds in the fund or is it partially a reflection of the demand for the particular fund?

We believe that individual bonds are better investments than bond funds for many reasons. We suggest that you check out our article "Buy Bonds and Not Bond Funds"[iv] posted on our website. However for those investors who can't buy individual bonds in their retirement accounts, here is a way to think about what bond funds to consider:

Are you concerned about interest rates rising? If so, consider only short-term or intermediate term bond funds.

Are you concerned about credit quality? If so, only buy high quality bond funds and don't buy junk bond, high yield funds, and emerging market or foreign bond funds denominated in foreign currencies. Look at the portfolio of bonds held by the funds and the ratings of the bonds in the fund.

Are you concerned about high volatility? If so, don't buy funds that hold bonds denominated in a foreign currency. The foreign currency may produce big gains or big losses. Consider bond index funds to provide wide diversification.

Are you concerned about high fees? Consider funds managed by Vanguard and Fidelity. They have no loads and reasonable fees.

Do you want big name managers with good records who manage for total return? Consider Pimco funds headed by Bill Gross and DoubleLine funds headed by Jeffrey Gundlach.

Whatever you decide, realize that when interest rates rise, the value of your bond fund will decline, and the bond funds will never come due. Like any other fund, there is no guarantee that your investment will be intact just because you chose to invest in a bond fund. It will fluctuate in value daily, and at some point may become quite volatile.

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[i] James Ramage. "Bond Buyer Indexes Down Across Broad as Interest Rates Plunge," *The Bond Buyer.* May 12, 2012.

[ii] Christine Albano. "Credit Quality Still a Key Attraction for Retail Buyers," *The Bond Buyer.* May 14, 2012.

[iii] Taylor Riggs. "Europe Fears Push 30-Year Yield to New Low," *The Bond Buyer. May 15, 2012.*

[iv] Hildy Richelson and Stan Richelson. "Buy Bonds and Not Bond Funds," *Advisor Perspectives. November 24, 2009. http://www.allbondportfolios.com/bond_article_11_24_09.pdf*