Bond Funds Instead of Individual Bonds

Not infrequently, a client asks us (or in some cases, confronts us) about why we use bond mutual funds rather than individual bonds. The arguments most typically presented to us go something like, "I can just buy actual bonds and hold them to maturity, so I know exactly what I'm getting and don't have to worry about losing money. Plus I get the regular interest payments, and I don't have to pay the expense ratio charged by a fund." In reality, though, there is more to the decision and there are some very significant benefits to using a bond mutual fund. Before we begin making our case, let's take a look at why we think some investors need to own bonds and how bonds fit into our asset-allocation process.

First and foremost, we view bonds as volatility reducers and not as income generators. In fact, we don't explicitly own any investments for the sole purpose of generating income. Instead, we manage portfolios from a total-return standpoint, utilizing a variety of investments (including bonds) that have varying degrees of correlation with one another. By mixing those assets in different configurations, we can create a portfolio with volatility characteristics that coincide with an individual's risk tolerance. Investors with long time horizons are generally most concerned with maximizing growth, so most of their money is in equity-like investments that have very good long-term return potential, but may have shorter periods of extreme volatility. Because short-term swings in the value of their portfolio are unimportant to that investor, they have less need for assets such as bonds or cash that can reduce volatility, and tend to have much lower return potential.

Other investors may be much more concerned about short-term volatility. Perhaps they rely on their investment portfolio to supply their living expenses. Or maybe they have a large financial obligation coming up in the near future (such as the down payment on a house, a new car purchase, or sending their kids to college), and they would be negatively impacted by a short-term drop in their portfolio's value. Those investors need to own assets that are unlikely to perform poorly if the stock market takes a spill, otherwise they could be in the unfortunate situation of having to sell equities from their portfolio right after suffering a big loss, and that can be potentially harmful in the long-run because it depletes the portfolio's capital at the worst possible time. Because bonds generally are not very volatile, they provide investors with an asset in their portfolio that is likely to hold up at least fairly well, even if their equity holdings are getting hammered by a bear market.

How do we handle this from a practical standpoint? When an investor needs to take money out for living expenses, we just rebalance their portfolio. If stocks have done well in relation to bonds, they would likely be overweighted relative to their target allocations, and we can trim them back to meet the client's withdrawal needs. Similarly, if the equity markets were down, the client's bond positions would probably be overweighted, and so we'd sell some of their bond funds.

Admittedly, this is a bit more work than having a steady stream of income coming in all the time, but it has a couple of key advantages. First, restricting yourself to income-generating securities limits your investment choices. With a total-return approach, you can own all kinds of investments: domestic and international equities, smaller-cap stocks, both high-yield and investment-grade bonds, and so on. By focusing more on income-oriented investments, you are casting a narrower net and have fewer options from which to choose. Furthermore, focusing on income generation isn't always very tax efficient. Sure, you can use municipal bonds that generate tax-exempt interest, but the yields on those bonds — and indeed most bonds these days — are not very high, so you'd need to own a lot of them to fund your living expenses (unless you had a very large investment portfolio). And having that much of your portfolio in bonds would compromise its long-term growth potential. A total-return approach enables you to shift a meaningful portion of your tax liability to long-term gains. Whenever you need to raise cash for your expenses, you can look at your portfolio and sell those securities that have the least onerous tax consequences associated with them. You could be selling investments with long-term gains (which are taxed at a lower rate than income), or possibly even sell investments that are underwater and generate tax losses. You have more control, and greater potential, to maximize after-tax returns.

So that is how we view portfolio construction and how to generate ongoing cash requirements. Now we will explain why we think bond funds are a better option than direct ownership of bonds.

The Argument for Bond Funds

One of the big myths about owning individual bonds is that you don't have to worry about losing money, or having the bonds depreciate. The truth is more complicated. Just because you own an individual bond and plan to hold it until maturity does not mean that its value doesn't fluctuate. All bonds move in response to daily changes in interest rates, credit conditions, and a host of other variables. On a really bad day, a 15-year Treasury bond could actually drop in value by a couple percentage points. If you needed to liquidate it for some reason on that particular day, you'd suffer a capital loss. If you were planning to hold the bond to maturity this short-term decline would not be an issue, but this implies the view that your cash requirements from the portfolio be generated from investment income. The total return approach we favor requires the flexibility to sell positions advantageously to generate any cash requirements (and holding bonds to maturity limits this flexibility), so in short, we don't think the trade-off is worth it. We understand the appeal of owning a bond to maturity, since a bond owner knows the value he or she will get at the end of the period, while a fund owner doesn't. But the appearance of added safety is more a function of simply not looking at the value of a bond along the way, while funds publish their prices each day. In reality, when a bond fund sees a price drop, it benefits more quickly from the higher prevailing yields that created the price drop. So, while you don't have a neat and clean terminal value to hang your hat on, history and bond math show that the chances of doing poorly in a bond fund versus owning an individual bond (or a laddered portfolio of bonds) over longer time frames is too small to outweigh the advantages of bond funds.

How volatile are bond funds? Their NAV (net asset value) changes every day in response to market conditions, but because most of these funds are highly diversified, these fluctuations are usually very small. The Lehman Aggregate Bond Index, one of the most widely followed benchmarks for the broad bond market, can serve as a useful example. We have almost 29 years of data for this index, and its average credit quality, maturity, and duration are used as guidelines for many conventional bond fund managers, and it is the primary benchmark we use for most of those managers. Over nearly three decades, the Lehman Aggregate's worst rolling four-quarter performance was -9.2%, which on its face seems pretty bad for a bond fund. But we also have to put this into context. First, this decline occurred at the end of 1979 and the beginning 1980, during the final throes of the worst inflation scare our country has ever seen: the Consumer Price Index soared from 6% to more than 14% between 1978 and 1980. So in an outlier event like that, it makes sense that bonds would get hammered. But it's also worth noting that in the four quarters following that 9.2% loss, the Lehman Aggregate rebounded more than 15%, most of which came in the first month (the index was up 11.3% in April of 1980). The next-worst four-quarter performance was only -3.2% during the cyclical bond bear market in 1994, and that came on the heels of several extremely good years for bonds. So the moral of the story is that the losses one might experience in a bond fund are not as bad as you might think, and are certainly no worse that what you'd face by owning individual bonds. (Sector-specific or long-duration bond funds may be more volatile than those that are benchmarked to the Lehman Aggregate due to the nature of the underlying bonds they hold.)

Also, simply "owning a bond" is not a guarantee against losing money. Treasury bonds and some mortgage-backed and agency bonds are either explicitly or implicitly backed by the federal government, so it's a pretty good bet that they aren't going to default on either their interest payments or return of principal. After all, the federal government can just raise taxes to cover its liabilities, which for all intents and purposes means a default isn't going to happen. Because this essentially makes them guaranteed investments, their yields tend to be lower than competing investments. All other bonds, on the other hand, have credit risk associated with them. This even includes AAA-rated corporate bonds. This super-high-quality debt is very unlikely to default, but it's not guaranteed, and unless you are prepared to do the credit analysis necessary to really understand the investment, you may be taking on more risk than you're aware of. Some investors may even buy a bond strictly on the basis of its yield alone, without investigating its credit quality. The risk with this strategy is that a high-yielding bond most likely has a higher probability of defaulting, in which case it could end up skipping some of its scheduled interest payments and you could even end up losing a sizeable portion of your investment. So owning individual bonds is not tantamount to a guaranteed return over a particular time horizon.

Aside from diversification, one of the biggest advantages of owning a bond mutual fund is that you can benefit from professional management at a very low cost. Bond fund managers spend all day figuring out what the best bonds are and how best to structure a portfolio. Realistically, most individual investors are not likely to do this much work. We'll be the first to admit that there are plenty of mediocre bond fund managers out there, but by owning a good one, you get several things:

- Added value from a wider investment universe. Most diversified bond funds can own bonds of different maturities, credit qualities, and sectors. This is a lot to look at, but fund managers are in a good position to evaluate the merits of one part of the bond market versus another and make smart decisions about the best place to invest.
- Better analysis. A good bond fund manager has the skill to assess uncovered opportunities and hidden risks.
- Better portfolio management. Do you know when it's best to use a barbell strategy versus a bullet portfolio versus laddered maturities? Do you know how to exploit the roll-down of the yield curve? Do you know the duration of your portfolio and how to manage it to adjust for expected changes in interest rates? These are just some of the portfolio management techniques used by bond fund managers to add value.
- Less impact from cash drag. This issue is somewhat more mundane, but very practical in that the interest generated by the bonds in the mutual fund are constantly being reinvested for you by the fund manager, rather than you having to do it yourself. Why does this matter? Because you really don't want that interest to wind up sitting in a cash account gathering dust before you get around to investing it; cash accounts don't generate very attractive yields, so money that is sitting there hurts your returns.

Another big advantage is that it's much easier to rebalance your portfolio and manage your asset allocation when using a fund, since with one simple trade you can change your bond allocation. This is much trickier if you're trying to manage a portfolio full of individual bonds, where you not only have to consider your total exposure to bonds, but also which individual bonds you own. And if your portfolio is relatively small, it may be much harder to fine-tune your asset allocation with individual bonds, since each is likely to be a meaningful percentage of the total portfolio. And remember, of course, that the crux of the argument for individual bonds is that you are not going to sell them.

Many bond funds have low expenses, and if they don't, you should think twice about owning them. We think it's reasonable to pay something for the advantages of liquidity, ease of use, and professional management. It may be slightly cheaper to own individual bonds, but this isn't necessarily the case, since individuals still have to pay trading commissions and often get less favorable pricing than institutional investors. So those who argue that owning individual bonds is "cheaper" probably aren't looking at the whole picture.

If you have a known, fixed liability at some point in the relatively near future, a short-term Treasury bond or CD might be a reasonable option. But for longer-term needs, we think bond mutual funds are the better choice. When picking a fund, you should make sure that fund has characteristics that are appropriate for your situation. By reading the prospectus and checking the fund company's website, you can get a sense for the fund's probable range for maturities, credit-quality, and duration (i.e., sensitivity to changes in interest rates). A bond fund with the same duration and credit quality as an actual bond will generally have similar volatility characteristics as the bond itself. In our model portfolios, we tend to stick mostly with intermediate-term, investment-grade bond funds, although we will sometimes combine funds with more varied characteristics that, when taken together as a whole, average out to a more conventional mix. But of course this can vary depending on our outlook for the bond market and what other investments we own in the portfolios.