

# Which are best, bonds or bond funds?

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Despite recent strength in the stock market, last year's crash has pushed many investors to seek returns in other sectors.

The massive flight of capital to the safest of vehicles, treasury bills and money market funds, has rendered paltry rates of returns; T-bills and cash equivalent accounts currently return next to nothing. Of the three major asset categories — stocks, bonds and cash — bonds may at this moment present the most palatable combination of risk and return to a conservative investor. Even risk seekers who perceive superior long-term prospects for equities can find value in lower volatility and assured income for a portion of their portfolios.

Although there are many types of fixed-income instruments available to individuals, the fundamental method of investing in bonds is rarely evaluated. Except for bank CDs and U.S. government savings bonds, most people buy bonds via mutual funds. There are situations in which this is the best choice. However, there are many for whom investing directly in bonds would provide benefits. One can earn more, control risk, and avoid unforeseen tax consequences with just a few moments of consideration, and action.

## Bond fund benefits

Bond funds have features entailed in any mutual fund, some of which are quite helpful. First, investors attain instant diversification, a feature not particularly important with government securities but absolutely vital with corporates.

Second, one can generally invest and withdraw money in any amount at any time — with the caveats that end-of-day pricing is used and processing takes place overnight, at best. For investors committing less than \$25,000, mutual funds probably make the most sense. For those investing more, building a portfolio of individual bonds may be preferred for the following reasons.

## 1. Maturity: Known versus never

One of the great stabilizing features of a bond is that it matures. Regardless of rate movements and other factors influencing security prices, at a date certain in the future a bond with \$1,000 face amount will return to the investor \$1,000. This is not the case with mutual funds. Fund share prices vary, as bonds in mutual funds are “marked to market” — meaning priced to where they would trade each day. Portfolio managers, meanwhile, buy and sell bonds frequently, often discarding securities well before maturity at whatever level is bid.

Simply modelled, if one buys a \$1,000 bond maturing in five years, aside from the interest earned one will receive precisely \$1,000 in five years. If one buys \$1,000 worth of a mutual fund that has an average maturity of five years, in five years one will own mutual fund shares that can be more or less than \$1,000 — depending on market conditions, management, and external fund flows.

## 2. Adverse shareholder behavior

This latter factor, external flows into and out of mutual funds, can create multiple problems for shareholders. The worst stems from a common behavior where people jump onto bandwagons, such as the dotcom boom and bust a decade ago. Less extreme, but damaging nonetheless, individuals shopping for funds most often look at recent performance. When rates fall, bond funds will show good performance, inducing trend-following investors to pour in money. When rates rise, bond funds fall, causing many shareholders to liquidate their holdings.

Combining these two tendencies, bond fund portfolio managers are forced to buy disproportionately when rates are low and to sell existing holdings when rates are high. One could be an expert economist and put money into a bond fund at exactly the right time but still end up with below average returns because of errant mass behavior forcing the fund manager's hands.

### 3. Unintended gains and losses

Another issue that can arise with funds is capital gains and losses. If one holds a bond to maturity, there is no tax consequence. With funds, two different capital taxable events can occur.

First, while holding fund shares, the portfolio manager may engage in transactions rendering capital gains and losses. The net amount of these events will add to or subtract from the shareholder's taxable capital gains. Second, when one sells fund shares, unless the sale price is exactly the same as the purchase price, a taxable event will have occurred. These effects are germane to municipal funds as well. If one buys and holds a tax-exempt municipal bond to maturity, there will be nothing to report to the IRS. If one buys municipal bond mutual fund shares, taxable gains may very well be generated and reported.

### 4. Management and fees

Fees and portfolio management go hand in hand. One can pick a portfolio solo and not pay anything. If choices are limited to treasuries, agencies, and FDIC insured CDs, much is indeed saved. If one delves into the higher return corporate sector, unless one can commit time to research, it is often wisest to get help.

The cost of such help varies greatly. Mutual fund management fees vary from about two tenths of a percent to well over one percent. Registered investment advisors who can build custom portfolios of bonds will charge anywhere from half a percent on up. Importantly, the value of such help varies as well. Last year the Oppenheimer Core Bond Fund, a staple "stable" offering in many Section 529 plans fell 36 percent.

### What to do

If you have money in cash equivalent accounts earning next to nothing, except for amounts needed for expenses over the next four to six months, start looking for alternatives. Whether alone or in consultation with a professional, come up with an appropriate asset allocation between stocks and bonds. Skipping stocks for the purposes of this article, view bonds as that part of your portfolio that seeks stable value but maximal income.

It's important to never pay a sales load of any kind, never pay a sales person to place your funds with a manager, and never buy bonds in a brokerage wrap account. In fact, never invest in a wrap account, period. Fees should be minimized, particularly with bonds in the current environment where a one percent annual charge will reduce expected income by 20 to 50 percent, depending on the chosen fixed income arena.

If the allocated amount is under \$25,000, use online screens such as those at Morningstar or a broker such as TD Ameritrade or Schwab to find no-load funds with low management fees in the sector you feel most comfortable with in terms of risk and return. Where available, read the reports, reviews, and ratings. Ignore all ads.

If the allocated amount is over \$25,000, start looking online at actual bonds. The mentioned discount brokers have excellent platforms. There are others. You can also contact an advisor to manage the bonds. You can avoid the pitfalls mentioned above, maintain full control of your risk exposure and end up with better returns.



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