NAIFA's advisor Today

Bond Fund Folly

With rising interest-rate fears and recovering equity markets, it may be time to reconsider other options.

By Terry Buffalo

An old Greek proverb states: "Anything good to know is difficult to learn." That adage is especially true when it comes to fixed income investing. For example, it takes considerably more time to become knowledgeable about individual bonds than it does bond funds. As an advisor, bond funds may be a convenient product, but that expediency can come at a heavy price for investors.

As an asset class, bond funds have performed relatively well over the past couple of years, delivering returns roughly comparable to individual bonds. During 2009, inflows into bond funds surged, and the continuing heavy inflow through 2010 will have an enduring impact on the markets and unsuspecting investors.

When the inevitable rise in interest rates occurs, the run on the bond fund market will mimic that of other recent bubbles. Investors relying on the funds for income, safety and "professional management" will be subject to severe share-price drops. The run, triggered by rising rates, will force fund managers to liquidate shares, further depressing prices and exacerbating the losses. Investors, hit with a double whammy, will take it on the chin. Again.

An advisor recommending individual municipal or corporate bonds can expect to spend more time explaining the various issues and rationale for his selection to investors. There will no doubt be questions, and the advisor will need data to support his recommendations.

While it's easier to recommend a fund from "one of the largest and best-known professionally managed bond companies," the extra effort associated with researching individual bonds can help preserve client capital, not to mention client relationships, down the road.

Lacking a maturity date, bond funds are unable to deliver predictability, one of the most important considerations in financial and retirement planning. In addition, funds typically have higher fees and the potential for loss of principal going forward. And as previously mentioned, the bond fund market has swollen to alarming proportions.

Importance of maturity
Bond funds are a perpetual investment since open-end funds have no maturity date. Money comes in from redemptions and is reinvested. There is no return of principal as there is with individual bonds, where a defined maturity date guarantees investors will receive a full return at par, in addition to the interest paid.

Bond prices may fluctuate but come the maturity date, the trading price of the bond is irrelevant. As such, volatility is immaterial, providing the advisor chooses the appropriate maturity to match each investor's needs and circumstances.

Investors are paid back at par, assuming the bond does not default. In the meantime, the bond's coupon pays a consistent income stream, which, in addition to value and portfolio balance, is the reason investors buy bonds in the first place.

Another reason to select individual bonds is that the most popular fixed- income strategies, such as laddering and bar-belling, can only be carried out effectively with individual issues. In the current environment, for example, a laddering strategy could be employed using fixed, floating rate and step-up bonds. That defensive strategy would not be possible using bond funds.

Predictability and timing are important considerations. If bond fund investors need money for a wedding, college or other contingency, they must determine how many shares of the fund they must sell at the current market price to realize the necessary amount. Depending on the price of the

shares at the time of need, investors may realize a gain or may take a loss on those shares. It's pretty much a timing crapshoot. On the other hand, the predictability of individual bonds circumvents the timing issue, unless an emergency occurs.

Comparing fees

Bond funds have ubiquitous management and transaction fees. While bond funds' typical 1 percent management fee may not seem excessive, there are other associated fees that contribute to the true cost. Commissions are another consideration.

Fees for individual bonds are much lower than those for bond funds: Upfront loads for funds typically run 4-4.5 percent. That disparity may also bring into play the issue of doing what is best for each client versus doing what is merely appropriate or convenient.

Another factor is interest rates. Each 1 percent rise in interest rates translates into roughly a 4 percent loss of market value. That's an enormous hit for investors to take, especially for retirees relying on capital preservation to generate a dependable income stream. Compound the problem with the erosion of capital due to inflation and the potential loss for bond fund investors is even greater.

Acquiring information

Fortunately, there are now websites where advisors and investors can review and compare virtually all available corporate and municipal bonds in order to properly align their income needs and time horizons with issues containing appropriate maturities and investment -grade ratings. Two sites for this are ***www.investingbonds.com*** and ***www.fixedincomeexchange.com***.

There are a great many more advisors specializing in equities than in fixed-income investing. Similarly, the majority of investors are more familiar and knowledgeable about equities than they are about bonds.

For advisory generalists, this lack of client awareness contributes to the tendency to use bond funds for the fixed-income portion of client portfolios. Interestingly, advisors who specialize in fixed income almost always use individual bonds instead of bond funds for the reasons mentioned above--predictability, lower cost and flexibility in setting strategies.

Specialists are also more cognizant of the potential for loss with bond funds and realize that if something does go wrong, they will be held accountable by their clients, not the firm, since they are the ones who made the recommendation.

It's already happening

The avalanche of money flowing into bond funds is beginning to reverse itself, the result of rising interest-rate fears, recovering equity markets and the usual investor herd mentality.

During 2009, approximately $396 billion moved into bond funds, according to a report by research firm Strategic Insight. Just $5 billion moved into equity funds during the same year. Through July 2010, $152 billion moved into bond funds and $24 billion into equity funds. While there is still a better than six-to-one ratio favoring bond funds, the trend away from them seems apparent.

As interest rates predictably rise, the impact on bond fund redemptions will be immense as investors run for cover, triggering liquidation spikes and principal losses worse than most can imagine.

Advisors with clients in bond funds may want to suggest that while it has been a satisfying banquet, it would be wise to leave while the dinner guests are still able to walk. It's always difficult to convince investors to leave a little on the table in the interest of avoiding indigestion, but in the case of the bond fund feast, now is probably a good time to move the party to the house next door, where they serve individual bonds.

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