BONDS VS BOND MUTUAL FUNDS

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Bonds vs Bond Mutual Funds: Beware of Hidden Dangers

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Since many of today's financial advisors got into the business in the 1980s and 90s, during the best stock market in U.S. history, most have become stock market specialists. Frankly, if they do fixed income, it's usually an afterthought, and most will simply take the easy way out and invest their clients' money in bond mutual funds.

What many people don't realize is that bond mutual funds carry risks, costs, and tax implications that can be reduced, or even eliminated, by investing in a diversified portfolio of individual bonds, or other fixed-income securities.

That's because when an investor buys an individual bond, they receive two important guarantees. First, they're guaranteed a fixed rate of interest for the life of the bond. Second, when the bond matures, they're guaranteed their principal back—assuming there have been no defaults. With that assumption, an investor knows what they're going to earn on the bond if they hold it to maturity. They also know the maturity date and the name of the company they are invested in.

But what about bond mutual funds? How do they compare to individual bonds?

For starters, both guarantees that come with individual bonds are "off the table," so to speak, when it comes to bond mutual funds. Bond mutual funds don't pay a fixed rate of interest. The interest they pay fluctuates. What's more, bond mutual funds never mature; your investment in the fund will continue until you decide to liquidate it.

Paper Loss vs. Real Loss

So, why does all this matter in the real world? The answer is interest rates.

Most investors understand the inverse relationship between interest rates and bond values. When interest rates go down, bond values tend to go up, and when interest rates go up, bond values tend to go down. If something happens to cause interest rates to rise and bond values to drop, a portfolio of individual bonds as well as bond mutual funds will both be affected.

However, if you're holding individual bonds, the loss is simply a "paper loss" because you have those two guarantees. Regardless of any fluctuation in the value of your bond on paper, your fixed interest payment will not change, and when the bond matures, you're still going to get your principal back, assuming there have been no defaults.

But, if you are holding bond mutual funds, you may never recover your principal if the funds do not recover, or if you need to liquidate for any reason. Remember, bond mutual funds never mature. This is partly what makes them riskier than individual bonds. With bond mutual funds, your loss isn't just a paper loss; it's a real loss.

Another big reason that investing in a bond mutual fund might not be in your best interest is the high costs associated with them. The fee structure of most mutual funds can be very complex, and these fees can end up eating away at the gains the fund manages to earn. These fees do not exist with individual bonds.

A 'Crutch' for Advisors

Why then do so many financial advisors utilize bond mutual funds instead of individual bonds? Well, as we noted, it could be because many advisors today got into the industry in the 1980s and 1990s, during the best stock market in US history. Since the stock market was providing such stellar returns in those days, many advisors became specialists in growth-oriented stock strategies.

In addition, since the analysis of stocks and mutual funds is much different from the analysis of fixed-income investments, many growth-oriented advisors will take the easy way out and just place their clients' money into bond mutual funds when asked about fixed-income investments. Instead of spending the time to research individual securities, they will advise you to invest your money in a bond mutual fund to give you instant diversification. Not only is this much easier for the advisor, but if the fund performs poorly, he can always simply blame the fund manager.

So, in a way, you can think of bond mutual funds as a "crutch" for growth-oriented advisors because they're leaning on a fund manager to pick the individual bonds for them. But like most things in life, simplicity comes at a cost. In this case, the cost is passed along to the investor, along with the added risks and stress that mutual fund investing can bring with it.

This isn't to say there isn't a time and place for investing in bond mutual funds. For instance, if you were an investor just starting out, and you didn't have enough capital to properly diversify in a portfolio of individual bonds, then at least bond mutual funds give you a way to leverage a low dollar amount to help diversify your portfolio.

However, for most people in or near retirement, who have saved their hard-earned money over a longer period, frequently the better option is to invest in a properly managed portfolio of fixed-income securities. Doing so means you're investing in accordance with what should be your top priorities once you're in or nearing retirement age: portfolio preservation and more reliable income.

Greater Certainty

Investing in income-generating securities is like lending your money to the largest U.S. companies that pay you regularly scheduled interest. In the case of individual bonds, at the end of the loan term, they send you the last interest payment along with the return of your original principal! Think of it like having a real estate contract where the tenant agrees to pay you monthly rent and then, after a certain number of years, buy the property from you at a pre-determined price!

By owning predominantly income-generating securities, prudent investors can know, with a greater degree of certainty, what their financial future holds. Other investment vehicles such as common stocks and mutual funds, by contrast, don't offer much certainty at all.

Take Action!

How can you learn more about investing for income? Simple: Contact a qualified financial advisor who specializes in the universe of income-based financial strategies designed to help protect your principal and generate more reliable income through interest and dividends. This is income you can spend or, if you don't need it, reinvest to grow your portfolio organically, or "the old-fashioned way!"

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