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A Tale of Two Strategies: Bond Funds vs. Individual Bonds

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In fixed income investing there is an on-going debate over the advisability of investing in bond funds versus investing individual bonds. Investment professionals on both sides of the argument have persuasively outlined the advantages and disadvantages of either approach. As the analysis has continued over the years, it seems that the only agreed upon conclusion is that the answer ultimately depends on the individual circumstances (age, health, employment status, tax bracket, net worth, investment understanding, etc.) and investment objectives (growth, income, preservation of principal, etc.) of the investor.

That being said, with the availability of online investing, and after evaluating their circumstances and investment objectives, investors are learning how easy it is to take advantage of some of the benefits of buying individual bonds. Hence, without much publicity, it appears to this author that the argument has quietly shifted in favor of investing in individual bonds.

In order to understand why this shift is occurring, it is important to first understand both sides of the bond funds versus individual bonds argument. Most writings on the subject have focused on the following investment traits:

(1) Diversification
(2) Reinvestment of income
(3) Investment control
(4) Cost
(5) Interest rate risk
(6) Liquidity
(7) Portfolio size

A brief discussion of each of these investment traits is outlined below.

(1) Diversification

Bond Funds: Because the underlying portfolio of most bond funds includes many different types of bonds of various maturities, investing in a bond fund conveniently provides the investor with immediate and widespread diversification. With numerous different bonds represented in the fund, the investor's exposure to the default /credit risk of any one issuer is minimized.

Individual Bonds: In this author's opinion, in order to achieve adequate diversification with the purchase of individual bonds, investors need about $100,000 or more invested in bonds of approximately 15 different issuers. The impact of a default will be greater within a portfolio of individual bonds than with a bond fund, because of the numerous and diverse holdings within a bond fund. When buying individual bonds, default /credit risk in most cases is addressed by limiting investment to essential purpose, high quality investment grade (preferably "A" or better) bonds.

Advantage: Bond Funds

(2) Reinvestment of Income

Bond Funds: Bond funds pay interest monthly in a fluctuating amount. Payments are based upon the interest received from the sum of all the investments held in the fund. As a result, the amount of income received varies each month. Because an investor can choose to automatically reinvest income by purchasing additional shares on a monthly basis, low yielding cash investments are typically held to a minimum.

Individual Bonds: Because individual bonds pay interest on a fixed, semi-annual basis, an investor is generally limited to reinvesting the income in short-term cash instruments until that amount exceeds $5,000. At that point in time, an additional $5,000 bond may be purchased for reinvestment.

Advantage: Bond Funds

(3) Investment Control

Bond Funds: When purchasing a bond fund, investors surrender control to the fund manager to make all investment decisions. An investor's involvement is limited to matching investment objectives and portfolio duration with the information contained in the fund prospectus. In addition, with investment in a bond fund, investors have no control over how much income they will be receiving during any particular period. Nor does an investor have any control over the timing of capital gains taxes, or determining whether or not bonds inside the fund portfolio are subject to AMT (alternative minimum tax) or are subject to the investor's state income tax.

Individual Bonds: Decision making responsibility and investment control remains with the investor when purchasing individual bonds. Individual bonds can generate a relatively predictable income with semi-annual interest payments and are redeemed at specific maturity dates. The investor has the opportunity to review the appropriateness of each investment including the use of AMT bonds and bonds issued from within the investor's home state. The investor purchasing individual bonds is also able to decide the type of issuer, maturity dates, call provisions and credit parameters for each investment.

Advantage: Individual Bonds

(4) Cost

Bond Funds: A bond fund may be purchased online through a brokerage account; and investors pays annual management fees and bond fund expenses. Shop carefully because these fees and expenses can range from .25% to 1.25%. A word of caution: depending on the bond fund selected, there can also be an up-front sales commission (load) charged (loads typically range from 2% to 4%) on the amount invested.

Individual Bonds: Traditionally, the cost of purchasing an individual bond was either the broker's commission or an unknown (to the investor) mark up on the price of the bond. Now individual bonds may be purchased online for an exact price at a flat commission per trade (for example: $10.95 per transaction with Zions Direct. Full Disclosure: Zions Direct is a non-bank subsidiary of Zions Bank, where I am a SVP and business development officer.), regardless of the dollar amount of the transaction. Online brokerage websites offer thousands of bonds representing the secondary market inventory of many broker/dealers. After individual bonds are purchased they are held in individual brokerage accounts and principal and interest is received, call redemptions (if any) are automatically processed and year-end tax information is provided.

Advantage: Individual Bonds

(5) Interest Rate Risk

Bond Funds: Because bonds in a bond fund are constantly being bought and sold, there is no specific maturity date for the money invested in the bond fund. Like all fixed income investments, the money held in the bond fund is subject to interest rate risk (an inverse relationship exists: when interest rates increase bond prices decrease and vice versa). Hence, when shares are liquidated they are sold at the current net asset value (NAV); and, depending on interest rate levels, the sale could result in a potential loss of principal. Generally, the risk of price volatility and fluctuating principal is higher for bonds with longer maturities.

Individual Bonds: Individual bonds have a defined maturity date. Interest rate risk is avoided by purchasing individual bonds with the intention of holding them to maturity. The market price of any fixed income investment fluctuates prior to maturity based upon the level and direction of interest rates. As a result, barring a credit default, if a bond is held to maturity it provides principal protection by being redeemed at par value, regardless of prevailing interest rates.

Advantage: Individual Bonds

(6) Liquidity

Bond Funds: With bond funds, liquidity is readily available. If a person needs money for an unexpected expenditure or desires to change asset allocation percentages, an investor may sell shares of the fund at anytime at the current NAV less redemption fees, if applicable. As previously mentioned, depending on interest rate levels, the sale could result in a potential loss of principal. Liquidating a portion of the bond fund changes the amount of the fixed income investment and does not change the characteristics of the fund portfolio.

Individual Bonds: Individual bonds can also be sold prior to maturity. The prices for bonds sold in the secondary market are influenced by prevailing interest rates and like mutual funds could be sold for more or less than the original investment. If some bonds are less liquid than others, those bonds may be subject to greater price volatility.

It is important to note that short term objectives and short term investments should not be mixed with long term objectives and long term investments. Hence, liquidity is best accomplished by holding money in short term cash instruments in order to provide funds for unexpected needs. Fixed income objectives should then be met by separately purchasing bond funds or individual bonds that will be held to maturity.

Advantage: Bond Funds

(7) Portfolio Size

Bond Funds: Most bond funds have an initial minimum investment of $5,000 and allow the investment of any dollar amount above the initial minimum. Hence, an investor is able to make a fixed income investment in a bond fund with a relatively small amount of money. Nor does the investor have a size constraint other than what prudence dictates by way of diversification needs and asset allocation strategies.

Individual Bonds: Most individual bonds are sold in $5,000 denominations and may be purchased in much larger blocks depending on the investor's net worth and available funds. However, in my opinion, portfolio size of much under $100,000 doesn't give an investor adequate opportunity to achieve an acceptable level of diversification either by issuer, bond type or maturity.

Advantage: ?

Conclusion

So what's the answer? Is it more advisable to invest in bond funds or individual bonds? Is the answer still determined by the summation of each investor's individual circumstances and investment objectives? Let's suggest an answer by reviewing some of the more obvious conclusions and allowing the reader to decide his or her own investor profile.

If an investor (a) desires as much diversification as possible in order to protect against default/credit risk, (b) is looking for a quick entry into the fixed income market with the on-going convenience of automatic reinvestment of interest earnings, (c) chooses not to be involved in the underlying investment decisions, (d) understands interest rate risk and that there could be a loss of principal if interest rates are higher when shares are sold, and (e) is willing to pay management fees and fund expenses.........then buy a bond fund.

On the other hand, if an investor (a) has at least $100,000 or more of investable, fixed income assets, (b) wants to retain investment control, (c) desires relatively predictable income, (d) intends to protect principal by holding bonds to maturity, and (e) is looking for lower expenses by virtue of buying bonds online directly from the secondary market.........then buy individual bonds.

It is this author's opinion that gradually more and more investors will be attracted to the advantages of purchasing individual bonds. And as investors learn the ease of buying individual bonds online, the investor shift from buying bond funds to buying more individual bonds will likely accelerate.

Nevertheless, decide which type of investor profile you are and start investing!

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