RIGHTPATH™
Investments & Financial Planning, Inc.

Bonds vs. Bond Funds: The Winner is…

Fall 2005

Bonds, or fixed income securities, play at least a supporting role in almost every investment portfolio, whether as the primary mechanism to reduce the risk of an equity, or stock, portfolio or in providing a steady stream of income for those investors funding current expenses. A critical question for investors is how to hold their fixed income component: direct ownership of government and corporate bonds or ownership of professionally managed bond mutual funds. Our analysis suggests, for the overwhelming majority of investors, mutual funds are the way to go.

Nothing in Life is Risk Free…

Like any investment, bonds are not without their risks:

- **Bond prices fall when interest rates rise.**
- **Issuers can—and sometimes do—default.**
- **When inflation surpasses the returns earned by bonds, the investor effectively is losing value.**

The Benefits of Owning Bonds

A broadly diversified investment grade bond portfolio has historically produced remarkably even returns with dramatically lower risk than a stock portfolio. Stocks have returned, on average, a little over 10% per year since 1926, while bonds have returned closer to 5%. However, in five of those years, stocks have lost greater than 40% of their value. The worst loss for intermediate term government bonds has been about 5%.

Of course, bonds have inherent risks, perhaps the biggest of which is “interest rate risk,” which produces losses in the value of a bond portfolio when interest rates rise. This phenomenon is much more evident in a portfolio of long-term bonds. Historically, in fact, the benefits of owning long-term bonds (with, generally, higher interest rates) have not been outweighed by this particular risk so it is advisable to keep the maturity of your bond portfolio on the short to intermediate side.

In addition, bonds have historically—although not always—had low correlations with stocks. Bonds tend to zig when stocks zag, buffering the performance of a diversified portfolio.

Why Bond Funds: A Substantial Cost Advantage

Many investors, with the help of a broker, are tempted to assemble and manage their own portfolio of individual bonds to execute their fixed income strategy. Most of these investors would be much better served using bond mutual funds, foremost because of the substantial cost advantage funds can offer.

In all asset classes, controlling costs is an extremely important factor in investment success. This maxim is especially true with bonds, where returns may be relatively small.

Buying and selling bonds comes with costs that are hidden from most investors. Rather than paying a commission to your broker, typically the firm is compensated by what is known as "the spread" or the difference between what the firm pays in the market and what you are charged. Because bonds have fixed coupons, paying the higher price to cover the broker's spread will lower your yield and the returns you will receive.

Recent reports from municipal bond regulatory agencies reveal a very dark side to the bond trading business. The municipal bond market is highly illiquid. Most issues are very thinly traded and a very few firms control much of the trading. Consequently, the spreads absorbed by the typical individual investor (trades between $25,000 and $100,000) are approximately 150 basis points (1.5%) more than the average institutional trader, such as a mutual fund, which makes trades in $1,000,000 lots and greater. Individual investors take a similar beating when they want to sell. The NASD has recently cracked down on even some of the nation's major brokerage firms for abusing some small investors in municipal bonds. Investors face similar hurdles in the corporate bond market.

Mutual funds, of course, have ongoing management fees. But it is generally far more cost effective to pay the fund's expense ratio over time and with the help of your fellow investors in the fund. One possible exception to this rule that bond funds are less expensive to invest in than bonds is to buy insured municipal bonds directly from the issuer (or treasury bonds) when interest rates are relatively high and when the investor has a high degree of confidence that the bonds will be held to maturity.

How Low is Low?

Of course, the benefit of low expenses afforded by bond funds is only realized when funds with low management fees are employed. Morningstar reports the average expense ratio for bond funds to be .90%. We generally admire funds offered by firms such as Dimensional Fund Advisors (DFA) and Vanguard. For example, DFA's Two-Year Global Fixed Income Fund (DFGFX) has an expense ratio of .23% and Vanguard's Intermediate-Term Investment Grade Fund (VFICX) has an expense ratio of .20%.

Additional Benefits of Bond Funds

- **Broad Diversification.** Mutual funds can own hundreds of holdings among different issuers, credit quality, and maturities, while an individual investor can, realistically, own only a few.
- **Professional Management.** Funds have experienced management and adept traders.
- **Better Cash Flow.** Bonds typically pay interest semi-annually. The investor in a bond fund can receive income on a monthly basis.

The Take-Home Lesson

While a few investor situations may indicate the direct holding of bonds, most investors will find that bond funds win the award of the fixed-income component of their portfolios with typically lower costs and reduced complexity. Of course, selecting from among the myriad of bond fund options can be overwhelming; and, as with all other portions of a portfolio, proper diversification is a must. Fortunately, financial planners usually have the tools at their fingertips to analyze how a fund would fit into a client's portfolio in terms of cost, diversification and other key factors.