Buena Vista Investment Management, LLC

Creative Investment Solutions

INDIVIDUAL BONDS OFFER SOME ADVANTAGES OVER BOND FUNDS

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Bonds have been one of the most popular investment categories of late. 2010 was another historic year for inflows into fixed income mutual funds. Individual investors held $1.23 trillion in actively managed bond funds at the end of 2010, which is a 60% increase in just two years. A lot of the motivation for this activity is likely a reaction to the stock market losses of 2008. Investors have been moving money to bond funds because they are typically less volatile than stocks.

However, as with any investment, there are tradeoffs. For one thing, actively managed mutual funds have costs associated with them that may not be known to many investors. According to the Center for Research in Security Prices, in 2010, the weighted average expense ratio of retail taxable bond funds was .82%. These fees are charged every year the investor owns the fund. So on a compounded basis; they can be a real drag on performance. And perhaps more important, bond funds are susceptible to interest rate risk, which means fund values fall when interest rates rise. So in a rising interest environment, investors lose twice, once from a mutual fund's internal fees and second from its drop in the fund's price.

Individual bonds provide a solution for dealing with both these issues. In a rising interest rate environment, individual bonds can lose value on paper, but if held to maturity the investor will receive their principal in full. Also, you don't have on-going fees with individual bonds like you do with funds.

BondDesk conducted a study and found the median expense for retail bond purchases was a total of .22%. Considerably less than the .82% per year cost for a mutual fund. And, unless a default occurs, when you hold a bond to maturity you receive your full principal, eliminating the same interest rate risk you have with funds.

Bonds can play an important role in a diversified investment portfolio. One benefit of diversification is that some years stocks will be the best performing asset category in your portfolio, and other years bonds will be the best performing asset. Therefore you get the effect of smoothing out the highs and lows in your portfolio. Another benefit of bonds is the provide regular income, which can be especially important in one's retirement years.

When most people look to invest in bonds, they look to mutual funds only. And while there are pros and cons with both approaches, it is probably worth your while to consult with your financial advisor about the advantages individual bonds may have over funds.