Bonds or Bond funds?

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What role do bonds play in a portfolio? The answer varies from one investor to the next but for most investors, they diversify and offset equity volatility. In addition, some investors are looking for bonds to provide a steady stream of income.

Bonds, especially high quality ones, generally do not move in sync with equities. During a bear market for stocks, bonds should outperform thus reducing overall portfolio losses. A younger investor with a high allocation to equity is primarily looking for bonds to limit the portfolio downside. In this case, the allocation to bonds would be a smaller portion of the overall holdings. How much exactly depends on the individual's age, appetite for risk, size of the nest egg, and the overall tolerance for volatility. Older investors who are closer to or in retirement might have a larger portion of their holdings in bonds. The main priority here is capital preservation, balanced with some growth. During retirement individuals may also be looking for a predictable source of income. Bond coupon payments can provide this supplement to monthly cash flow.

Bonds do play a vital role in a portfolio, but the amount of fixed income and the particular sector of the bond market is determined by individual goals and circumstances. After deciding on a bond allocation, what is the best way to invest? Do you buy individual bonds or a mutual fund?

There is no right or wrong answer but again it depends on your personal situation. Individual bonds are single securities that pay a fixed interest payment, usually twice a year. As long as the issuer of the bond does not default, principal is paid back on a set maturity date. It is predictable and the exact return is known with certainty. This can be useful for someone with a known expenditure at some point in the future or when building a portfolio of bonds to generate a steady income stream. Bonds work well for investors that have a large enough nest egg to construct a portfolio of bonds across different maturity dates and sectors of the fixed income market. A bond ladder is an effective tool for those with a sizeable nest egg. The risk becomes too concentrated when holding just one or two bonds.

Treasures are the safest and most straight forward sector of the market; however, investors looking for more yield will have to look to corporate bonds or high yield. These come with added risk

but in return pay more in semi-annual income. High yield bonds may be attractive in an improving economy. This is where personal goals come into play. Income focused investors with a very low allocation to equity can stand to take on more risk in the bond portion of the portfolio. By contrast, a portfolio with a high allocation to stocks and a goal of counterbalancing equity risk would not choose the corporate sectors of the market. These bonds increase the corporate exposure already existing in the stock component of the portfolio. Furthermore, the high yield market is highly correlated with equities so it may seem you are diversifying, but the equity risk is not counterbalanced. This goal is better accomplished with treasuries or agency bonds, which are negatively correlated with stocks.

Municipal bonds are another way to reach for a little more yield than treasuries offer. They can offer tax-free income so are a good choice in a taxable account. However, not all municipal bonds are tax-free. These bonds, called taxable-municipals, can be used in tax-sheltered accounts like an IRA, and the yields can be directly compared with other taxable bonds.

Owning individual bonds can be advantageous for tax purposes because the investor has control over the timing of sales. A mutual fund cannot pass through realized losses to the shareholders of the fund.

Bond funds are similar to open and closed end stock funds. Investor money is pooled together to purchase bonds in one or more sectors of the bond market. Shares of the fund are purchased at a daily NAV price, and a professional manager selects bonds to buy. As with stock funds, benefits include convenience, liquidity, and access to a large diverse mix of bonds with only a small amount of capital. Unlike a bond, you do pay an annual expense ratio for as long as you hold the fund. There are monthly income payments but they fluctuate, and there is typically no contractual date when the fund must pay back your principal.

Some funds will focus on one sector of the market, say government bonds or corporate bonds. Other funds represent the market as whole. Funds are professionally managed, which can be helpful when looking for exposure to emerging markets or high yield. These areas require more diligence in monitoring an issuer's credit worthiness. For an individual investor this may not be feasible so a bond fund is a better choice.

Often times it is said that by owning a bond, the holder is resistant to fluctuations in market price as long as the bond is held to maturity. While it is true the principal remains intact, depending on the size of the nest egg, an investor may be better off in a fund for the diversification benefits. For

example, if a bond within a fund defaults, it is a small percentage of the holdings and the overall investment would be down to a much lesser extent than if a portfolio held only two or three individual bonds and experienced a default. Investors in mutual funds still need to be mindful of exactly what the fund is invested in. Diversification does not mean you are completely protected. For example, investors found themselves unknowingly invested in Puerto Rican bonds within a mutual fund. This is because mutual funds that focus on a particular state will at times add a small allocation to other unrelated high yield type investments as a way to enhance their yield.

Both bonds and bond funds are adversely impacted by a rise in interest rates. Some ways to manage the risk of rising rates is to shorten the maturities, as the longer dated bonds are more sensitive to market rate moves. Construct a bond ladder so that bonds mature each year allowing the investor to buy new bonds at the higher rates. Move into sectors that are less sensitive to interest rates.

In the end no one knows for sure what the next move will be in the market so it is not a good strategy to move in and out of fixed income based on rate predictions. It is best to evaluate your personal goals and preferences, pick a fixed income allocation and stay the course. It is to be expected that the fixed income portion will underperform in equity bull markets and outperform during a down turn. What is important is achieving an overall return that will grow your investments while not taking on more risk than necessary.