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Are Individual Bonds Really Better Than Funds?

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Suze Orman: wrong about bonds?

By Allan S. Roth

In the continuing debate over whether it is preferable to own bond funds or individual bonds, many financial experts come down on the individual-bonds side of the fence. Suze Orman has certainly stated the case many times, as has MarketWatch writer Jonathan Burton, who wrote a piece on the subject earlier this year that appeared in The Wall Street Journal. Burton succinctly stated the case against bond funds (emphasis mine):

> *If interest rates climb in future years, as is likely from today's very low levels, the prices of existing bonds with lower rates will fall. The impact may be felt more keenly by holders of bond mutual funds and exchange-traded funds than by investors who have bought individual bonds.* ***The latter have the option to collect their bonds' full face value at maturity, while bond funds don't mature.***

The thrust of the argument is that building a laddered portfolio of individual bonds eliminates the interest-rate risk from potential rising rates. This argument, appealing as it might be, is simply wrong, though I'll have to use a bit of math to prove why.

Debunking the Myth

Let's say an investor buys a one-year corporate bond at a $1,000 face value that pays a 4% interest rate at the end of the year. She expects to get back $1,040 in a year. Her bond is worth $1,000 today because the market pegs the 4% rate as a fair rate for this type of bond. The math behind it goes like this: $1,040/1.04 (one plus the interest rate) = $1,000.

In this hypothetical example, immediately after she buys the bond, news comes out of increasing inflation expectations and suddenly investors want a 5% yield on this type of bond. Looking up the value of her bond, she finds it is now worth only $990.48 ($1,040/1.05), declining by $9.52. Still, this investor may take comfort in not having lost a dime as she is still going to get the $1,040 back, which is exactly what she bargained for.

Unfortunately, she is only going to receive $40 interest when the market now demands $50 interest for this type of bond. This translates to receiving $10 less in one year, based on the current 5% return expectation. The investor is immediately out $10.00/1.05, which is exactly equal to be the $9.52 decline in value of her bond. Not merely a coincidence. The math always works out the same irrespective of the interest rate or the maturity of the bond. That is to say, the change in the current value of the bond will be equal to the present value of the cash to be received from the interest payments and the return of principal.

Simply put, if interest rates increase, the value of the fixed interest payments and the return of principal declines. Holding the bond until maturity does nothing to protect the investor from increasing interest rates. The investor just receives less money than the current market would dictate.

William Bernstein of Efficient Frontier Advisors in Eastford, Conn., puts it as follows:

> *It's true; when rates rise, the price of your mutual fund falls, but from that point forward you're getting the market rate of interest. With individual bonds, you won't take a loss at maturity, but until then you have to bear the pain of a crummy coupon. With the bond fund, you're ripping the bandage off quickly; with the individual bond, you're doing it slowly. The end result is precisely the same.*

Still need a little more convincing? Consider a different example of a bond that pays the investor $1,000 in 10 years but does not pay annual interest payments. Upon maturity, this "zero coupon" bond would offer very different amounts of buying power if annual inflation averaged 2% vs. 10%. In the former case, it would buy about $820 worth of goods in today's dollars but, in the latter case, only about $386. Thus, they have a very different maturity value in real, inflation-adjusted terms.

Superiority of a Bond Fund

Good bond funds such as the [Vanguard Total Bond](#) are low-cost and diversified. In return for a 0.1% annual expense ratio, investors can buy into a laddered bond portfolio with an average maturity of 7.2 years. If interest rates increase, the value of this bond fund will decline. Each year, however, bonds will mature in this fund and be replaced with higher-yielding ones. This is exactly the same as owning the individual bonds until maturity.

So for a low fee, the investor gets benefits they can't get by owning bonds directly, not the least of which is a professionally managed laddered bond portfolio, diversified with 5,385 bonds instead of a dozen or two. Because of the fund's size, investors get the savings of buying in bulk and minimizing transaction costs.

By buying funds, investors do have to give up the illusion that they can eliminate interest rate risk by owning individual bonds and holding them until maturity.

And while bonds don't reduce interest-rate risk, there is a different fixed-income strategy that will at least minimize it. Buying certain CDs with low penalties is an alternative strategy I recently wrote about that provides higher yields without risk.

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