Checking Safety: Are Individual Bonds Safer Than Bond Funds?

Saturday's With Jim

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Dear Friends,

A serious turndown is not in sight, but neither was the Global Financial Crisis in sight to most people before it ravaged the global economy and many countries' social structure. Today we discuss our account "safety net," our allocation to bonds.

What Is The Difference Between Individual Bonds and Bond Funds?

There is some allocation to bonds in all of our portfolio(s), more for the volatility-averse and less for those comfortable that short-term volatility won't result in damage to a 20-year or more investment program. Bond funds are collections of individual bonds, held to support specific published objectives. Individual bonds are IOUs given by governments, state or local government authorities or special jurisdictions, which may or may not have taxing authority. Bonds, like stocks, are bought and sold on secondary markets (stock and bond markets) once they have been bought by a primary buyer from the issuer. Bond funds are diversified, holding many issues of varying maturities. If one bond defaults, the whole bond portfolio does not go down. Unlike stocks, most bonds mature and pay the principal to the bond holder. Bonds and CDs are very similar – they are debts of the issuing institution. But bond prices are not stable before they mature, as CDs are.

The Power of Bond Funds and Individual Bonds

Investors who want individual bonds have the full power to buy specific bonds and the quantity they want. They know exactly when each bond will mature and collect interest twice a year at the stated rate on the bond coupon. Investors who want bond funds invest in a portfolio of tens to hundreds of bonds that are bought and sold by professional managers who charge a management fee for their research and selection prowess. Bond fund investors cannot control the exact mix of bonds they hold, but they can choose the fund(s) that best suits their needs. Smaller investors can easily buy bond funds, instantly gaining a well-diversified bond portfolio.

Pitfalls of Bond Funds and Individual Bonds

Bond fund investors have a huge advantage over individual bond investors in all but U.S. government markets. Bond funds have millions and billions under management and can almost control an industry, gaining very advantageous terms when they buy their portfolio holdings. Bonds are not generally sold on exchanges like stocks are, so there may not be an orderly market for bonds for either the individual bond buyer or seller.

Individual bond buyers pay large spreads (buyers pay premium prices over the selling price to give middle people commissions and to pay transfer expenses), while bond funds often get bonds at very near their par value. Individual bond buyers most often plan to hold their bonds until maturity, because if they don't a good portion of their profit could melt away due to spread costs between the buy price and the sell price. But individual bond investors know exactly what they have, as we mentioned earlier. Bond fund investors know after a month or more what they held on a certain date (exchange traded bond fund investors know from day to day what they hold). Bond mutual funds could be subject to waves of selling pressure akin to a bank run, when investors fear the loss of their money due to some systemic failure or another. Nowhere is the illiquidity of bond funds (they have to sell securities to raise cash to pay selling investors) more apparent than when these funds hold illiquid securities en masse. Thus, it is incumbent on bond fund investors to read prospectuses carefully so they can understand what specific risks the funds present.

So what?

We all need bonds in some proportion to provide liquidity, if we should need it, and to afford greater safety than stocks offer. We believe that the well-heeled bond investor with several million dollars to invest and who is knowledgeable about bond investing can benefit from a carefully selected portfolio of individual bonds. The rest should high tail it to the best bond fund of choice and invest there, so they can be certain that their bonds won't blow up their investment program should a wave of defaults hit. The greater safety and diversification offered by bond funds over individual bonds is a great inducement to a good night's sleep.

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.

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