

SHOULD YOU INVEST IN INDIVIDUAL BONDS OR BOND MUTUAL FUNDS?

Bonds had a miserable year in 1999. One of their worst on record. Yet countless articles, investment newsletters and commentators are touting a return to bonds as an antidote to an increasingly volatile stock market.

Many Certified Financial Planner practitioners recommend owning bonds regardless of where the bond or stock market is at any given time. Owning bonds help diversify one's portfolio. But should you invest in individual bonds or bond mutual funds?

Investing in individual bonds offers several advantages over bond mutual funds. First, you know exactly what you're getting in the way of interest payments and maturity. You lock in the price, the yield to maturity or call, and the cash flow. You can buy an individual bond with a maturity date that matches a specific investment goal, such as a child entering college. With a bond fund, earnings aren't fixed and the fund never matures. It is designed to maintain a certain average maturity or duration (long-term Treasuries, for example).

Short of default, an individual bond will return all principal and pay all interest assuming you hold it to maturity (or redemption if the bond is called). Bond funds are not likely to default (though individual issues in the portfolio might), but they can't promise full return of principal at maturity, either. With individual bonds, you can choose when to buy or sell a particular bond, which has tax and cash-flow advantages.

Individual bonds also don't incur the ongoing management and operating expenses of bond funds. Of course, individual bonds have their associated expenses, including brokerage commissions or fees (unless you buy U.S. Treasuries directly from the federal government), bid-ask spread and the cost of selling individual issues.

The issue of ownership costs of individual bonds versus bond funds was recently examined by the Schwab Center for Investment Research. It found that the cost for investors who hold individual

Treasury, corporate or municipal bonds at least five years is on par or even lower than comparable costs for buying low-cost bond funds – if the investor owns at least \$50,000 in worth of individual bonds.

The big advantages of bond funds are diversification, liquidity, purchase cost, the availability of reinvested dividends and professional management.

Buying individual bonds can be expensive. A single corporate bond might run \$10,000 or more, whereas an initial investment in a bond fund might cost only \$2,000 to \$3,000 – less for an individual retirement account. An exception is Treasury securities, which you can buy for only \$1,000 each.

The generally high cost of buying individual bonds prevents many investors from sufficiently diversifying among different issues. A bond mutual fund might hold hundreds of bond issues, thus reducing nonpayment and default risk. An individual investor should probably own at least ten or more bonds from different issuers, with the exception of Treasury securities.

Selling shares of bond mutual funds is typically much easier than selling individual bonds, although the market for Treasury securities and government agency bonds is quite liquid. Early liquidity can be a cost concern. The Schwab Center for Investment Research emphasizes that holding a minimum of \$50,000 in individual bonds compares favorably with bond funds if the investor doesn't have to liquidate earlier than five years. Investors concerned about early liquidation may be better off sticking with funds.

For investors who don't need the cash flow, reinvested dividends is another advantage for bond funds because they usually are automatically reinvested. Interest from individual bonds, typically paid every six months, cannot be automatically reinvested. Unless the interest is enough to buy a new bond, you'll likely have to put it into a money market or savings account, where it will probably earn less interest.

The last major advantage of a bond fund is that professional management takes care of all the details, from analyzing the credit markets to choosing which bonds to buy and sell.

Ultimately, the decision whether to buy individual bonds or bond funds comes down heavily on the size of your portfolio, your knowledge of the bond markets and your cash flow and investment needs.

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