Misconceptions About Individual Bonds vs. Bond Funds

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Investors have been nervous about the possibility of rising interest rates for a number of years now. Since bond prices fall as interest rates rise, this possibility has many investors worried about their exposure to interest rate risk. A common refrain on reducing this risk that I have heard many times over the years goes something like this:

I don't want to be caught owning bond funds in a rising rate environment. It's much safer to own individual bonds and simply hold them to maturity. That way I am assured of getting my principal back and not taking any losses.

Sound familiar? I always find it fascinating when investors assume they can completely avoid risk in their portfolio without any ramifications. In this case, the individual bond advocates miss out on a few key points.

Cliff Asness wrote a great piece for the Financial Analysts Journal a few years ago detailing his top ten pet peeves about the investment industry. Number ten was the fallacy that owning individual bonds is really any different than investing in a bond fund:

Bond funds are just portfolios of bonds marked to market every day. How can they be worse than the sum of what they own? The option to hold a bond to maturity and "get your money back" (let's assume no default risk, you know, like we used to assume for US government bonds) is, apparently, greatly valued by many but is in reality valueless. The day interest rates go up, individual bonds fall in value just like the bond fund. By holding the bonds to maturity, you will indeed get your principal back, but in an environment with higher interest rates and inflation, those same nominal dollars will be worth less. The excitement about getting your nominal dollars back eludes me.

But getting your dollars back at maturity isn't even the real issue. Individual bond prices are published in the same newspapers that publish bond fund prices, although many don't seem to know that. If you own the bond fund that fell in value, you can sell it right after the fall and still buy the portfolio of individual bonds some say you should have owned to begin with (which, again, also fell in value!). Then, if you really want, you can still hold these individual bonds to maturity and get your irrelevant nominal dollars back. It's just the same thing.

I've sent this piece to a number of investors over the past couple of years, but most still needed some more convincing. Here are a few more points to consider:

Risk never completely goes away. You're still dealing with all of the same bond risks as every other investor when you buy individual bonds — interest rate risk, credit risk, inflation risk, duration risk, default risk, etc. It's just a form of mental accounting to assume that you'll be able to ignore short-term losses in individual bonds with the knowledge that the principle value will be there at maturity. To which my response is this — if you're willing to ignore short-term losses in individual bonds, why can't you ignore short-term losses in bond funds?

Costs and complexity. Buying an individual bond is not exactly a walk in the park. For the most part, they're illiquid. The costs are much higher to trade. Most of the cost you'll never be able to quantify because you won't be able to tell if you're getting a good deal on your trade or not if you're not an expert. The spreads tend to be much higher on bond trades than what you see on stocks. You also have to research and understand which types of individual bonds you will be buying. When income payments are made you have to figure out where to reinvest the proceeds. Then you have to figure out what to do with your proceeds all over again when the bond matures.

When do you need the money? Really the only reason that owning an individual bond would make sense is if you needed that amount of money on a specific date. Let's say you know you need this money in exactly five years for your child's college education bills.. Sure, maybe then owning an individual bond might make sense. But bond funds are much easier to deal with if you're slowly accumulating wealth or slowly taking distributions from your portfolio over time. Most people who own individual bonds probably reinvest their principal right back into new bonds, which is exactly what bond funds do.

Diversification. Not only do you diversify your holdings by owning a bond fund, which severely reduces default risk, but you also diversify your cash flow stream. Think of a bond fund like something of a perpetual dollar cost averaging vehicle. In a bond fund you have bonds with different maturities, yields and durations. Most funds hold thousands of bonds so the individual holdings are constantly maturing. This allows bond fund managers to reinvest maturing bond proceeds into the new market interest rates. When rates rise, this is a huge plus for bond funds because they can continuously reinvest at higher rates, which offsets some of the sting you get from the price decline. Yes, you have a maturity date with an individual bond, but this ignores the opportunity cost of investing at higher future rates in the meantime.

I'm all for investors doing whatever they need to do to meet their goals and sleep soundly at night while doing just that. Maybe individual bonds can give some people the peace of mind they need. But I think there are a lot of misconceptions about the differences between individual bonds and bond funds. Investing in individual bonds does not shelter you from risk. Bond funds have risks too, but you may be taking unintended or unnecessary risks by investing in individual bonds if you don't understand how these things work.

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