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Comparing Individual Bonds and Bond Mutual Funds

Individual bonds and bond mutual funds are both valuable fixed-income investments that can be positioned within portfolios in an attempt to meet certain goals and objectives. Understanding the key differences and risks between individual bonds and bond mutual funds will help the investor assess which type of investment is better suited for their particular investment needs.

A Closer Look at Investment Bonds and Bond Mutual Funds

	Individual Bonds	Bond Mutual Funds
Principal Preservation	Returned at maturity (or the call date, in the case of callable bonds).	Based on various market conditions and the value returned may be less than the original investment.
Predictable Income	Some bonds, such as those with fixed coupon rates, allow investors to predict the interest payment stream expected.	Income streams can be less predictable.
Ownership	Investors own the underlying security.	Investors own shares in the fund.
Portfolio Control	Investor controls what bonds are held in the account at all times.	There may be a certain amount of turnover based on the decision of the fund manager.
Fully Invested	Fully invested at all times.	Bond fund managers must keep a portion of the funds in cash ready for redemptions.
Yield to Maturity	Investors know the exact yield to maturity (or yield to first call date) at the time of purchase as long as the bond is held to maturity.	With bond funds (like stock funds), neither the income nor maturity value can be known in advance.
Ongoing Fees & Expenses	A transaction fee is typically included in the purchase price of the bond. The stated yield accounts for this charge, and there are typically no additional costs incurred until the bonds are sold, called, or mature. There are typically no ongoing expenses.	Management fees and other operating expenses affect the performance of bond funds.
Diversification	Building a diversified portfolio of bonds can require a significant investment.	Diversification can be achieved with lower initial investment.
Tax Considerations	Fairly predictable based on the terms of the bond.	Uneven income stream and can have unexpected end-of-year capital gains distributions.
Future Value	At the time of purchase, investors know the expected future value of the bond if it is held to maturity.	A bond fund's net asset value will move in response to factors such as interest rates and credit quality. Overall cash flows in and out of the fund may also impact the net asset value. Because it tracks interest rate fluctuations, the future value of a bond fund (unlike individual bonds) cannot by known with certainty at any point in time.
Intereste Rate Risk	Generally, the interest rate risk of a bond tends to decline as it approaches maturity.	Due to a fund's constant maturity, the risk is likely to remain constant throughout the entire time the investment is held.
Transparency	Investors know what they own.	Due to portfolio managers buying decisions, investors may not know what they own.
Liquidity	Bonds are generally considered less liquid than stocks and funds. Liquidity will vary based on the bond's characteristics and other market conditions. Lack of liquidity may result in price volatility. Callable bonds can be called prior to maturity at a predetermined price.	Can sell fund shares at any time, at the current market value (NAV) of fund, less redemption fees, if applicable.

Interest Rate Risk

If interest rates rise, bond prices usually decline, and if interest rates decline, bond prices usually rise. This inverse relationship is important to understand. The longer a bond's maturity, the greater the interest rate risk. A bond fund with a longer average maturity will see its net asset value (NAV) react more dramatically to changes in interest rates as the prices of the underlying bonds in the portfolio increase or decline. The effect that interest rates have on the prices of bonds owned by the fund will cause the income that the fund distributes each month to vary.

Credit Risk

Bonds carry the risk of default, meaning that the issuer is unable to make further income or principal payments. Many individual bonds are rated by a third party rating agency such as Moody's or Standard & Poor's to help describe the credit worthiness of the issuer.

Bond funds are typically classified as investment grade-quality (medium – high credit quality) or below investment grade-quality, depending on the individual bonds in which they invest. Credit risk is a greater concern if the fund invests in lower-quality bonds such as high yield bond funds. The fund's prospectus will describe its credit quality policies.

Other risks, such as default risk and call risk, are typically mitigated because a bond fund is made up of many individual bonds. By owning a large number of bonds, the impact of any one bond defaulting or being called away prior to maturity (forcing the fund to reinvest the proceeds at a lower, prevailing rate of interest), is lessened.

Performance of a Bond Fund

Because the performance of a bond fund is determined by the performance of its underlying investments, it may be helpful to review the basics of bond fund investing before looking closely at fund performance. However, past performance is not a guarantee of future results.

Share Price

Every bond fund has a net asset value (NAV), or share price, which is the dollar value of one fund share. The NAV is based on the value of all the securities in the portfolio and typically fluctuates daily.

Yield

Yield of a bond fund measures the income received from the underlying bonds held by the fund. The 30-day annualized yield is a standard formula for all bond funds based on the yields of the bonds in the bond fund, averaged over the past 30 days. This figure shows you the yield characteristics of the fund's investments at the end of the 30-day period. It does not indicate the fund's future yield. The 30-day yield also helps you compare bond funds from different companies on a standard basis.

Total Return

A bond fund's total return measures its overall gain or loss over a specific period of time. Total return includes income generated by the underlying bonds themselves and price gains or losses of the bonds in the portfolio. Investors should focus on total return when evaluating performance of bond funds.

Deeply rooted in the fixed income markets since 1979, Advisors Asset Management, Inc. (AAM) provides financial professionals with comprehensive access to the bond market in conjunction with simple and efficient trading support. AAM is a value-add resource offering relevant insights and portfolio ideas. Speak with your investment professional to learn more about fixed income securities and the role they can play in your diversified investment plan.

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