FREE

BONDS VS. BOND MUTUAL FUNDS

Are you making mistakes that could jeopardize your retirement?

Topics Covered:

- Guaranteed a fixed rate of interest for the life of the bond
- The hidden dangers behind investing in bond mutual funds
- When the bond matures, they're guaranteed their principal back - assuming there have been no defaults
- How to help avoid one of the most devastating financial mistakes a retiree can make

BEWARE OF THE HIDDEN DANGERS BEHIND INVESTING IN BOND MUTUAL FUNDS

Since many of today's advisors got into the business during the 1980s and 90s, in what was the best stock market in U.S. history, most have become stock market specialists. Frankly, if they do fixed income, it's usually an afterthought, and most will simply take the easy way out and invest their clients' money in bond mutual funds.

What many people don't realize is that bond mutual funds carry risks, costs, and tax implications that can be reduced, or even eliminated, by investing in a diversified portfolio of individual bonds, or other fixed-income securities.

That's because when an investor buys an individual bond, they have two important guarantees. First, they're guaranteed a fixed rate of interest for the life of the bond. Secondly, when the bond matures, they're guaranteed their principal back – assuming there have been no defaults. With that assumption, an investor knows exactly what they're going to earn on the bond that they hold to maturity, they know at what date it will mature, and they know the name of the company they are invested in.

So how, then, do bond mutual funds compare to individual bonds?

Both guarantees that are inherent in individual bonds are "off the table", so to speak, when it comes to bond mutual funds. First, bond mutual funds don't pay a fixed rate of interest. The interest they pay fluctuates. Secondly, bond mutual funds never mature; your investment in the fund will continue until you decide to liquidate it. So, why does this matter in the real world?

Most investors understand the inverse relationship between interest rates and bond values. When interest rates go down, bond values tend to go up, and when interest rates go up, bond values tend to go down. If something happens in the bond market to cause bond values to drop, a portfolio of individual bonds as well as bond mutual funds will both be affected.

However, if you're holding individual bonds, the loss is simply a "paper loss" because you're going to still receive your fixed interest payment for the life of the bond, and when the bond matures, you're still going to get your principal back assuming there have been no defaults.

But, if you are holding bond mutual funds, you may never recuperate your principal if the funds do not recover, or if you have to liquidate for any reason. Remember, bond mutual funds never mature. This is part of what makes bond mutual funds riskier than individual bonds.

Another big reason why investing in a bond mutual fund might not be in your best interest is the high costs associated with them. The fee structure of most mutual funds can be very complex, but these fees can end up eating away at the gains the fund manages to earn. These fees do not exist with individual bonds.

Why then do financial advisors utilize bond mutual funds instead of individual bonds? As we mentioned earlier, it could be because most advisors today got into the industry during the 1980's and 1990's, in what was the best stock market in US history. From 1982 to 2000, the Dow Jones Industrial Average went from 1,000 to almost 12,000.

Since the stock market was providing such stellar returns, many advisors became specialists in growth-oriented, stock market-based strategies. And, since the analysis of stocks and stock mutual funds is much different from the analysis of fixed income investments, many stock market-based advisors will often take the easy way out and will just place their clients' money into bond mutual funds when asked about fixed-income investments.

Instead of spending the time to research individual securities, many advisors will just advise you to invest your money in a bond mutual fund to give you instant diversification. One of the benefits, for the advisor, is that if the fund performs poorly, they can point the finger at the fund manager.

So, in a way, you can think of bond mutual funds as a "crutch" for stock market-based advisors because they're leaning on a fund manager to pick the individual bonds for them. But like most things in life, simplicity comes at a cost. In this case, the cost is passed along to the investor, along with the added risks and stress that mutual fund investing can bring with it.

This isn't to say there isn't a time and place for investing in bond mutual funds. For instance, if you were an investor just starting out, and you didn't have enough capital to properly diversify in a portfolio of individual bonds, then at least bond mutual funds give you a way to leverage a low dollar amount to help diversify your portfolio.

However, most people in or near retirement, who have saved their hard-earned money over a longer period of time, are better suited to invest in a properly managed portfolio of fixed-income securities. This will help in preserving their retirement savings and generating reliable income well into retirement.

One Final Word of Caution about Mutual Funds

One of the biggest dangers behind investing in any type of mutual fund is something known as reverse dollar-cost averaging — which is one of the most common and potentially disastrous financial mistakes a retiree can make.

Most people know what dollar-cost averaging is and have used it wisely in the course of saving for retirement. The purpose of dollar-cost averaging is to get your average purchase price down to help you buy low and sell high, which is the cornerstone principle of smart investing.

For example, if you decided to invest $100 each month in a bond mutual fund and in the first month, each share of the fund was worth $10 a share, you would be able to buy 10 shares. Now, let's say the market performed poorly the following month and each share of that same fund was only worth $5 per share. If you stuck with your plan of investing $100 per month, you would be able to buy 20 shares with your $100.

After the second month, your average cost per share would seem to be $7.50, but, it would actually be lower. That's because you bought twice as many shares at $5, and half as many shares at $10. Through dollar-cost averaging, you were able to get your average cost per share down to about $6.65.

This strategy works well when you are in the contribution stage of retirement investing. The problem arises when you reach the point where you're not saving into your fund anymore, and you start drawing funds from the principal balance of your savings for things like IRS required minimum distributions. The same principles apply but now in the opposite direction. You are now reverse dollar-cost averaging.

Taking the same example, let's say that in the first month you need to liquidate $100, so you sell 10 shares. In the second month, the fund's price per share once again drops in half. Now, to withdraw your $100, you would have to sell twice as many shares. So, now what's your average sales price per share? Again, the math is the same: now instead of taking your purchase price down from $7.50 to $6.65, you've taken your sales price and pushed it down. You've been forced by the IRS to sell low instead of high.

To understand the potential dangers of spending principal during retirement, let's consider a 30-year retirement like a 30-year mortgage in reverse. When you first start making mortgage payments, you're not paying back much principal at all. Instead, you're paying primarily interest and only a small amount of principal. As the years go on and the balance gets paid down, you pay a little less interest and a little more principal. The process continues until, after 30 years, your mortgage is paid off.

Now, let's imagine the same process in reverse. Take a pool of savings worth $1 million, generating 5 percent interest per year, or $50,000. If you take even just a little bit more than the $50,000 each year, just a small amount of your original principal, your $1 million in savings will be depleted within 30 years in much the same way that a mortgage is paid off.

Know, with Greater Certainty, What Your Financial Future Holds

Investing in income-generating securities is similar to lending your money to the largest U.S. companies that pay you regularly scheduled interest. In the case of bonds, at the end of the loan term, they send you the last interest payment along with the return of your original principal.

By owning predominantly income-generating securities, prudent investors can know, with a greater degree of certainty, what their financial future holds. Other investment vehicles such as common stocks and mutual funds don't offer much certainty at all.