OLLI-GMU Investment Forum

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Bonds 101, Part 4

Individual Bonds Vs Bond Funds

Summary: Rules of Thumb

You might have one or more of the reasons below when you choose to hold individual bonds or bond funds. You could hold both bonds and funds. Each may serve a different purpose in your portfolio.

- Use **individual bonds** when you want more control:
  - You need to match cash needs to specific dates
  - You want predictable dividend income
  - You are ok with locking up principal until maturity
  - Can accept meaningful loss from defaults
  - You want to pick your own bonds
  - You just enjoy buying and selling bonds
  - You want to eliminate fund management fees
- Use **bond funds** when you prefer flexible, easy buying and selling:
  - You want continuous holdings as a volatility damper against stocks,
  - You are ok with a variable dividend each month
  - You want easily liquidated “dry-powder”
  - You want funds’ broad holdings to absorb default hits
  - You want a fund to pick risky or complex bonds
  - You’d rather do less work; it’s not fun for you

1. When Individual Bonds Are Appropriate

Individual bonds excel w**hen you have a specific timeline for cash needs, or desire greater control** for the fixed income portion of your portfolio

- **You need to match cash needs to specific dates - aka Liability Matching:** If you know you will need a specific lump sum of money on a precise future date (e.g., funding a specific milestone, matching a future tax liability, saving up for a purchase, or planning around Required Minimum Distribution cash flows), buying an individual Treasury or high-grade corporate bond maturing on or near that exact date ensures the principal is returned right when needed.
- **You want predictable dividend income:** Let's say you need a fixed stream of cash at regular intervals; individual bonds can help. Since bonds have a stated coupon interval and a fixed maturity date, you always know how much dividend income you will be receiving from now until maturity.
- **You are ok with locking up principal 'til maturity:** If you are fairly certain you won't need the principal until maturity, you can ignore price fluctuations and accept the dividends as they roll in. However, if you have to sell the bond for emergency cash needs, you may incur a loss.
- **You can accept meaningful loss from defaults.** Since each bond costs $1,000 and you cannot buy and sell fractions of bonds as you can with stocks, it takes a lot of capital to build a large enough portfolio to dampen the effects of one or two bonds defaulting. For example, even if you have bonds from 20 different issuers, you might incur a 5% loss if just one of them defaults.
- **You want to pick your own bonds to have more control:** Let's say that you believe five-year bonds are the sweet spot of risk versus yield. You can create a five-year bond ladder. That way, you are consistently buying 5-year bonds. Or, let's say you don't want to buy bonds from companies that you object to (e.g., cigarette companies). You get to pick and choose.
- **You just enjoy buying and selling bonds:** Some people just like the thrill of the hunt. Some want to manage gains and losses. For example, when interest rates fall, you can get a capital gain on a bond that you bought when rates were higher.
- **You want to eliminate fund management fees:** For cost-conscious investors with *sufficient capital* to build a diversified ladder, individual bonds eliminate the drag of annual fund expense fees. This is somewhat offset by the fact that bond fund professionals get better prices on bonds than us retail investors.

2. When Bond Funds Are Appropriate

Bond funds are ideal for investors seeking broad exposure, operational simplicity, and dynamic management across the yield curve.

- **You want continuous holdings as a volatility damper against stocks:** If your fixed-income allocation is meant to be a permanent, perpetual volatility dampener in your portfolio rather than tied to a specific calendar date, a bond fund's lower price volatility and income stream lessens an overall stock/bond portfolio's downturns. While the bonds in the fund do mature, the cash is reinvested in new bonds. Hence, there is no date on which the fund has a fixed value.
- **You are ok with a variable dividend each month:** Bond funds hold many bonds. The funds are constantly buying and selling the bonds in the portfolio. As a result, the monthly or quarterly payouts are not fixed. They are just whatever dividends were paid by the issuers over that time period. Also, a fund might hold various derivative products to manage risks. Buying and selling these changes the payouts.
- **You want easily liquidated "dry-powder":** If you require the ability to enter or exit your fixed-income position at a moment's notice during market hours without navigating individual bond dealer quotes & bids, bond ETFs provide superior daily liquidity. Funds can be "dry powder" for trading or for rebalancing in stock downturns. Also, as rates fall and bond funds' NAVs rise, you can sell or trim and collect profits.
- **You want funds' broad holdings to absorb default hits:** A typical bond fund will hold thousands of bonds. Yes, some of those will default, but you will hardly notice it in the overall value of the fund. Also, professionals have more data about risks than we do.
- **You want a fund to pick risky or complex bonds:** Professional fund managers have the skills to buy more kinds of bonds than retail investors. They can buy junkier, higher-yielding bonds than we can so they can generate more income. You pay a small management fee for the fund's expertise. Also, retail investors buy in small quantities and thus get worse prices. Some of this advantage, however, is lost when we have to pay the management fee for the fund. Also, this is an easy way to diversify your bond holdings into areas into which you could not easily buy individual bonds (e.g., Bank Loans, Emerging Market Debt, etc.).
- **You'd rather do less work:** You buy a bond fund, either an ETF, a closed-end fund, or a mutual fund, just like you buy stocks and stock funds. There is a wide variety to choose from, and you can get just what you want. Also, in a managed fund, you rely on the fund manager to adjust factors like duration and credit risk to trade off between safety and returns.

Key Structural Differences

What causes bond funds and individual bond holdings to work differently?

Feature	Individual Bonds	Bond Funds (ETFs & Mutual Funds)
Maturity & Principal	Have a fixed maturity date. If held to maturity, you receive your full par value back (barring issuer default), regardless of interim price drops.	No maturity date. The fund continually buys and sells bonds, maintaining a rolling average duration. Principal fluctuates with market rates.
Diversification	Requires significant capital to build a diversified portfolio across multiple issuers and sectors.	Instant diversification across dozens or hundreds of individual issues with a small investment.
Costs	No ongoing management fees if held to maturity. Costs are embedded in the bid-ask spread at purchase.	Incurs an expense ratio (annual management fee), though many broad index bond ETFs are very low cost.
Liquidity & Trading	Can be less liquid, particularly for corporate or municipal bonds in odd-lot sizes. Selling before maturity exposes you to market spreads.	Highly liquid (especially bond ETFs, which trade intraday on exchanges like stocks).
Cash Flow Predictability	Generates predictable, fixed semi-annual coupon payments and a known lump-sum return of principal on a specific date.	Yield and monthly distributions fluctuate as older bonds mature and new bonds enter the portfolio at prevailing market rates.

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