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Bonds vs. Bond Funds: A Distinction Wealth Advisers Should Explain

Clients should understand that funds don't offer the same downside portfolio protection

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7 COMMENTS

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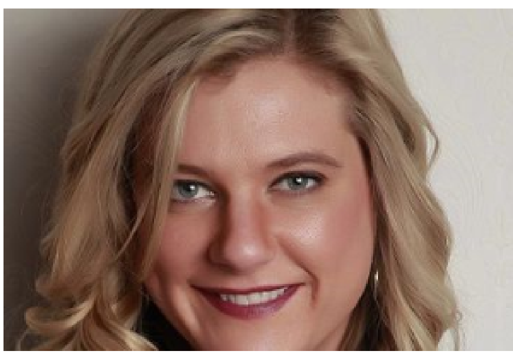

Ms. Joelson on bond funds and the rising-rate environment: What might seem to investors like a safe bet may not be. PHOTO: META POINT ADVISORS

Since the early 2000s, bond funds have become increasingly popular vehicles for individual investors seeking to diversify their portfolios. Just this fall, flows into bond exchange-traded funds topped $100 billion for the year. And that popularity is understandable—for most clients, affordable access to a diversified bond portfolio is challenging.

But the issue with bond funds is clients' perception, or misperception, of how they actually work. In particular, clients tend to conflate bond funds with individual bonds. It's a dangerous misunderstanding and one that we as advisers need to do a better job of communicating.

The traditional appeal of individual bonds is their ability to provide clients with steady, predictable income and downside protection for their portfolio. With a bond, the principal is repaid at maturity unless the issuer is in default. Though interest rates may increase and your bond may be worth less on the secondary market, if you hold on to that bond until maturity, you should get your initial investment back.

Bond funds on the other hand, although they contain bond assets, do not provide investors with the same kind of guarantee. While bond funds generate income for investors, their value fluctuates in the market. And in our current rising-rate environment, that's a significant difference. What might seem to investors like a safe bet may not be.

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In the past year, iShares 20+ Year Treasury Bond ETF (ticker: TLT) and iShares TIPS Bond ETF Inflation-Protected Treasury (TIP) bond funds—composed of less-risky government bonds—delivered negative returns. Meanwhile, the iShares Core U.S. Aggregate Bond ETF (AGG)—which is the largest bond fund by assets under management and is slightly more aggressive in terms of its risk profile—gained just 0.8%, according to BlackRock iShares. A client paying a 1% management fee to their adviser, however, would lose money on that investment.

Despite that performance, most robo-advisers are still putting clients into bond funds, touting them as a means offsetting volatility in their portfolios. As advisers, it's important for us to explain how bond funds differ from individual bonds and provide potential alternatives. Unfortunately we no longer live in world of 5% bond returns, and there really aren't vehicles that can provide the kind of risk/reward profile that fixed-income securities once did.

One potential solution to this problem is using a bond ladder with individual bonds as a sort of proxy bond fund. Clients still get a portfolio of bonds with staggered maturities, but they have the advantage of the principal protection and predictable income that they forgo in a bond fund or bond ETF. If clients are comfortable investing in less liquid vehicles than a bond fund, bond ladders could be a good choice.

The time to have these conversations is now, to make certain that our clients understand the vehicles they're using so they can make informed decisions about how they're mitigating risk in their portfolios.