

Bonds or Bond Funds?

By Matt Rice, MBA/CFP®
Vice President, Pile Wealth Management

The question of whether you should invest in individual bonds or bond funds depends upon the goals you are trying to achieve. You need to understand the differences between individual bonds and bond funds. Once these differences are identified you can then implement the strategy that maximizes the odds of accomplishing your specific goal.

Individual bonds provide a known level of income and a known cash flow at a specific time in the future (subject to the creditworthiness of the issuer). This is beneficial to investors seeking to match income and expenses and can be an especially important planning tool for retirees. Bond funds fluctuate in value and have no specific, determinable value at a future date. Investor's with fixed obligations can match those obligations with bonds, not bond funds.

Investors purchasing individual bonds pay a one time charge at the time of purchase or sale. Bonds held to maturity can therefore have lower costs because the internal management fees are eliminated. In addition, investors seeking to control capital gains taxes can do so with individual bonds. Capital gains taxes are paid only if a bond is sold for profit prior to maturity. A bond fund charges an annual expense to investors and incurs capital gains taxes when a fund manager sells bonds for profit. The bond fund investor is giving up control of both costs and capital gains taxes. Investors should keep in mind that even municipal bond fund investors must pay taxes on capital gains distributed by the fund. Investors can negate the capital gains issue by purchasing bond funds in tax-advantaged accounts, such as IRAs, where possible.

Achieving diversification is an important consideration when building an individual bond portfolio. Pile Wealth Management recommends investors have \$500,000 invested in fixed income before considering individual bonds. A second criterion to consider is bond quality. Investors seeking high yield or "junk" bonds will have a difficult time constructing a diversified individual bond portfolio. Bond funds invest in hundreds of bonds, providing investors with instant diversification and professional management. While a bond may default within a fund, the impact to the investor will be much smaller than it would be in an individual bond portfolio. Investors constructing an individual bond portfolio should consider only high quality bonds. If you determine that your portfolio should have some component of high yield bonds, these should be purchased through a fund, to achieve diversification.

Every investment should be looked at in relation to both the investor's goals and in relation to its impact on the overall portfolio. Bonds and bond funds both serve as important assets for investors and must be considered when constructing a globally diversified tax-efficient portfolio. Investor's that have the requisite assets should consider individual bonds in order to gain control over cash flow, expenses, and taxes. Pile Wealth Management provides access to a team of experienced Fixed Income professionals available to assist clients in identifying and implementing the appropriate solution.