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FIVE THINGS EVERY INVESTOR SHOULD KNOW ABOUT BOND FUNDS

by Thomas Collimore, CFA, Director, Investor Education , and
Gregory Seals, CFA, Director, Fixed Income and Behavioral Finance

Whether you're considering a bond fund because you have lost confidence in the equity markets or are looking to diversify your portfolio, do your homework. Fixed-income instruments are more varied than you might think, and many investors underestimate the risks. Some bond funds lost more than a quarter of their value during 2008. Here are some things to keep in mind when evaluating bond mutual funds.

INVESTMENT INSIGHT

Duration is a measure of average maturity used by investment professionals. It is a measure of interest rate risk. Specifically, it approximates a fund's price change in response to interest rate changes. For example, a fund or individual bond with a 10-year duration can be expected to change in price by approximately 10 percent when interest rates change by 1 percent. A fund with a 5-year duration might change in price by 5 percent when interest rates change by 1 percent.

1. Don't be a yield chaser. Higher yields do not necessarily translate into higher realized returns. Yield is not the same thing as total return, and as a matter of fact, higher yields are usually associated with a higher probability of default. The yield-to-maturity (YTM) calculation that managers use to describe their fund is just that—a description. It's one characteristic of the overall portfolio and is not necessarily a representation of what that fund will earn. The calculation does not assume any change in principal, whether due to defaults or selling prior to maturity, both of which will affect performance. Make sure you understand, and are comfortable with, the degree of risk associated with any fund you choose.

2. Match the fund with your liquidity needs. Many investors view bonds as a "safer" investment than other asset classes, such as stocks. But bond funds, even those in the ultra-short category, shouldn't be used as a replacement for cash equivalents like money markets or CDs; bond prices can fluctuate, so there is a possibility that you'll lose some principal. When you're considering a bond fund, think about the time horizon of your investment goals. If your time horizon is short (less than five years), look for a fund with a low duration (two to three years). This will reduce the amount of interest rate risk the fund contains. Long-term funds can be risky and are inappropriate for those who may need to withdraw their investments in a few years.

3. Watch expenses. As with any other mutual fund, you should carefully consider expenses. In addition to any front- or back-end sales load associated with your initial investment, there are ongoing annual expenses the manager charges to the fund. These fees and expenses directly affect the fund's return and vary widely among funds.

Expenses have a more noticeable effect in low-interest-rate environments when bond yields are low. If you are paying 1 percent in management fees and the yield on your fund is 5 percent, you're effectively losing 20 percent of your return to fees. Be aware of implicit trading expenses that are related to the fund's turnover and the liquidity of the underlying securities but are not listed as management expenses.

Morningstar® Category[1]	Average Expense	Low Expense[2]	High Expense
Long-Term Bond	0.88%	0.07%	1.99%
Short-Term Bond	0.92%	0.09%	2.14%
Ultrashort Bond	0.70%	0.20%	1.58%
High Yield Bond	1.20%	0.15%	2.73%
Emerging Markets Bond	1.34%	0.53%	2.24%
Muni National Long	1.02%	0.12%	2.79%
Muni National Short	0.82%	0.12%	1.83%
High Yield Muni	1.15%	0.53%	2.56%

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4. Consider Treasury Inflation-Protected Securities (TIPS). If you're concerned about inflation, think about adding TIPS to your portfolio. TIPS pay a stated rate of return plus an adjustment for inflation as measured by the U.S. Consumer Price Index. They are useful for investors who want to maintain purchasing power and desire the safety of a bond guaranteed by the U.S. government. As with other bonds, TIPS prices will fluctuate based on changes in interest rates and market sentiment, so make sure you take your liquidity needs into account when you make your decision.

5. Diversify your portfolio with municipal bond funds. In addition to tax advantages, muni bonds are a good way to add diversity to your portfolio. At almost $3 trillion in size, the muni bond market is as broad as the corporate bond market, not only in geographic diversification but also in sector diversification (hospitals, special assessments, tobacco bonds, etc.). Historically, they have been less volatile than other asset classes, and defaults in muni bonds are rare occurrences. The same rules apply to muni funds as any other bond fund: Match your duration with your future income needs, and watch out for high expense ratios.

Investing in bond funds isn't a guarantee of safety. Bonds are not as simple as coupon payments and return of principal. You should consider credit risk, duration, and liquidity when making your investment choices. Bond funds should be considered in the context of a broader investment plan that takes your personal preferences and risk tolerance into account.

Frances Melville and William Ortel contributed to this article.

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[1] Data were extracted from the Morningstar Fund Screener (www.morningstar.com) on 22 July 2010.

[2] Excluding funds that have temporarily waived or are receiving reimbursement of expenses.

For more information, please consult http://www.cfainstitute.org/investor/

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