INVESTING IN BONDS OR BOND FUNDS IN A RISING RATE ENVIRONMENT
Investing in Today's Economy

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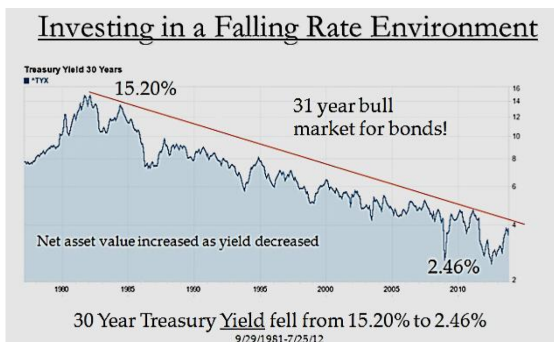
Fixed income securities, including individual bonds and bond funds, have historically been the primary tool used to generate income for retired investors. However, the task of generating income has become very difficult. Interest rates are at near record lows and monetary policy uncertainty evidently has resulted in increased bond market volatility. In spite of the low interest environment, investors have poured over $1 trillion into fixed income bond funds and ETFs over the last five years. Since the fixed income markets have recently seen a small rise in interest rates, now may be a good time to look at the pros and cons of owning fixed income in a fund vs. owning individual bonds or alternatives in a rising rate environment.

Bond Funds

In our view, one of the great benefits of investing in bond funds is that they provide instant diversification. Most bond funds hold hundreds of individual bonds, and the impact of a single issue being downgraded, or even defaulting, would be minimal. Bond funds also provide liquidity and pay a monthly distribution of income. However, the monthly income amount can fluctuate, and this often provides uncertainty for an investor who requires a specific level of income. Bond funds have several major drawbacks: first, they are pooled investments, and when investors redeem their shares, it can affect the value of other investors' shares in the fund by creating trading costs and possibly forcing the bond manager to sell bonds they otherwise would not. Second, bond funds have no maturity date. Hence, in a declining bond market, the risks can be appreciably higher than the risks of owing individual bonds that will accrete to par value as maturity approaches.

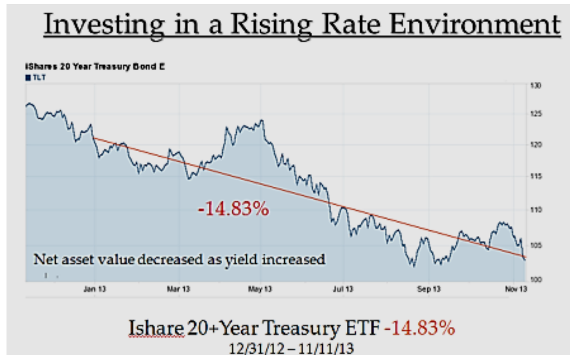


Although a record amount of inflows into fixed income over the last five years, over the last few months, investors have liquidated over $20 billion which may be attributed to the small rise in interest rates. Imagine what could happen if investors representing half of the net flows of bonds over the last five years panicked (due to a quick and significant jump in rates) and liquidated their shares. The stampede for the door would be unprecedented, and it would cause unknown liquidity issues in the markets. Bond fund managers would

be required to sell bonds to meet redemption requests. They might even need to sell quality holdings at a time when prices would be pushed down due to a lack of buyers.

The result of this panicked selling would be twofold. Shareholders who remained invested in the funds would see a decline in the net asset value of the funds, which could have a further effect of driving prices even lower by selling out in a panic situation. Those losses would be "booked" in a sense, since bonds sold at a loss obviously cannot be held to maturity.

Individual Bonds



Building a diversified individual bond portfolio takes time and we believe requires the expertise of a professional manager. However, there can be many advantages to holding a separate account comprised of individual bonds. Individual bonds offer regular fixed payments. Unless there is a default, and current default rates are close to historical lows, the investor's principal will be returned incrementally when each bond matures. Bond funds, on the other hand (as mentioned above), do not mature.

An individual bond portfolio held in a separate account could allow the owner to control their own destiny. The owner is not affected by other investors' selling or buying activity. A panicked sell-off in the fixed income markets or a rise in rates would result in a decline in bonds prices. It would lower the account value for the individual bond holder. However, if held to maturity, the individual bonds would regain all of their "paper losses" at maturity.

If principal stability and a fixed rate of interest are your primary investment objectives and if — a big if — you are a long-term investor not swayed by fear, a portfolio of individual bonds managed by a professional may be a better choice in a rising rate environment. However, as always, be sure that the investment you choose corresponds with your objectives.

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"Providing Retirement and Income Solutions"

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