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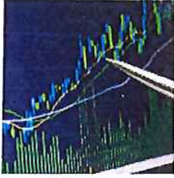

Great Speculations

Buys, holds, and hopes

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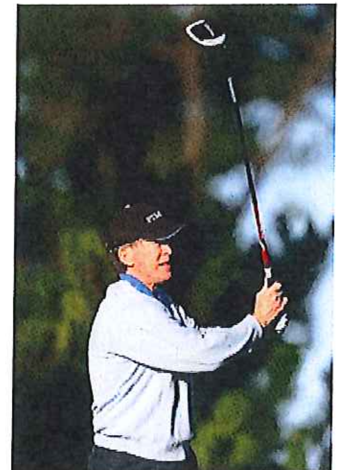
Bond Funds Are For Losers, Be A Winner With Your Own Ladder

Ken Winans, Contributor



Bill Gross, chief investment officer of Pimco (Image credit: Getty Images via @daylife)

The great corporate-bond bull market continues unabated with the Dow Jones Corporate Bond Average up 46% since 2008. The iShares iBoxx Investment Grade Corp. Bond (LQD) ETF is up 4.5% year-to-date. The below-investment grade has stayed above water, with the SPDR Barclays Capital High Yield Bond (JNK)ETF and iShares iBoxx High Yield Corporate Bond (HYG) up 2.8% and 3.5%, respectively.

If you have decided that the stock market is too volatile and that you want to switch to the historical safety of bonds, you are not alone. The baby boomers are retiring and need investment income, and bonds can provide more certainty of overall investment return during soft economic times.

So, how should you proceed?

You have probably been told by somebody wearing a nice suit and wielding a persuasive pie chart, to put your money into a bond mutual fund instead. The most popular is Bill Gross's Pimco Total Return fund, with $261 billion in assets. If your objective is stable future income, you've been told wrong.

If you own shares of any of the nine other large bond mutual funds in the table below, sell them. Instead, buy a basket of bonds that suit you, or purchase a low-cost index fund like Vanguard's Intermediate-Term Bond Index.

Many popular bond funds, including Bill Gross's beloved Pimco Total Return, churn their holdings at a fast clip. Most underperform Vanguard's comparable benchmark fund.

Fund	Symbol	Yield	10-year Performance	Annual Turnover	Expense Ratio	Assets (billions)
Vanguard Intermediate-Term Bond Index	VBIIX	3.3%	6.7%	61%	0.22%	$15.6
Managers Pimco Bond	MBDFX	3.4%	6.6%	495%	0.58%	$1.3
Wells Fargo Advantage Total Return	WTRZX	1.8%	5.9%	761%	0.86%	$3.4
Pimco Total Return	PTTAX	3.5%	6.4%	584%	0.90%	$260.9
Lord Abbett Core Fixed Income	LCRAX	2.8%	5.6%	669%	0.87%	$1.0
Transamerica Partners Core Bond	DVGCX	3.0%	5.0%	406%	0.98%	$0.4
Hartford Total Return	ITBAX	3.0%	4.9%	131%	0.95%	$1.9
GuideMark Core Fixed Income Service	GMCOX	1.7%	4.9%	427%	1.26%	$0.4
Schwab Total Bond Market	SWLBX	2.8%	4.2%	166%	0.49%	$1.0

Source: Morningstar.com

Let me explain why. The eight funds in light yellow on our table all offer low yields, high expenses and lots of rapid-fire turnover. I think those are a recipe for poor performance, and the eight funds' 10-year track records back up my view. They've all underperformed Vanguard's cheap, Intermediate-Term Bond Index, which has lower turnover. It also pays a higher yield than most of the managed funds.

When I used to lecture to MBA students at St. Mary's College of California, I liked to explain that all investing comes down to owning and loaning. Owning refers to buying investments, such as common stocks or real estate. Yes, these can produce painful setbacks in bear markets, but the best of them appreciate sharply over the long term.

By loaning, I meant providing funds to a sovereign government, a local municipality or a public corporation by buying bonds, notes or bills. As with any loan, the focus should be to garner consistent, reasonably secure income from interest and enjoy the certainty of knowing the exact date you'll receive your original principal back.

Many bond mutual fund managers apparently don't get it. They trade their bond holdings frenetically in hopes of capturing gains in price appreciation. They seem almost uninterested in the significant cash flow produced by simply holding onto these investments.

Your friends may like bond funds. Municipal-bond funds are the most popular, with over 702 open-end and 287 closed-end funds to choose from. However, just because something's popular doesn't mean it's the right way to invest.

The best way to utilize these investments in a portfolio is by directly own them. (Last year I proposed a handful of bonds I thought were worth owning.) And yes, for small investors who can't afford to own many different bonds, it's worth looking into index funds and exchange-traded index funds. But keep your eye on what matters: You're making a loan. Stay focused on the near-certain return you'll get by collecting regular payments of income and the legal obligation to pay back the principal regardless of the economic climate.

I've been managing income portfolios for more than 20 years. Here are six rules I follow when investing in bonds on behalf of my clients:

1. In order to achieve stable, predictable income, I ladder fixed income portfolios by year and plan to hold bonds to maturity or call date.
2. I remind myself that not all bonds are the same. I shop for the best yields among corporate, treasury and municipal bonds.
3. I do my own research on the issuers and ignore most agency ratings.
5. When yields are generally low, I prefer bonds with maturities of 10 years or less. It's tempting to chase the higher yields offered by long-term bonds, but when interest rates inevitably increase, long bonds get hammered.
6. To reduce the effect of an individual bond defaulting, diversify the bond portfolio by issuer, industry, maturity, and position size. Have a disciplined approach to selling troubled bonds.

To minimize income taxes, I put taxable bonds in tax-deferred accounts and amortize bonds bought at premiums to par value.

It's easier for retail investors to buy bonds than it used to be. Discount brokerage houses now offer much more access to income investments. An investor with as little as $75,000 can cost-effectively invest in a well-balanced portfolio of 15 bonds.

If you decide to work with a full-service investment advisor, be cautious of the stock-picker who professes to be a skilled buyer of bonds as well. A good stock picker doesn't automatically possess sharp bond-investing skills. Ask for client references.

What about bond mutual funds like those in the table above? Unfortunately, many investors embraced income-investment products, including bond mutual funds, as equal substitutes for buying and holding bonds. In reality, a large number of these investments don't mature and do not provide a projected rate of interest income. In the next major market correction, they will prove to have all too much in common with stock funds. Their investors will discover that nothing is certain—not income, not maturity, nothing.

If you are looking for a 'buy and hold' investment strategy that actually works in soft economic times, though, forget stocks and look into corporate bonds.