THE NEW ENGLAND GUILD
MEMORANDUM

The Case for Bond Funds

We were dismayed to see a recent newsletter of another investment advisor, whom we respect, severely condemn the use of bond funds for an individual investor's portfolio. The article strongly recommended that individuals hold individual bonds in their portfolio in place of bond funds. Their reasons were as follows:

1. Bond funds never mature, unlike bond securities that have specified maturity dates. Therefore there are no guarantees that the funds will ever get back to even at some point in the future.
2. They argue that investors have a tendency to put money into bond funds at the worst possible time, after interest rates have fallen, and that they liquidate shares after interest rates have risen and bond prices have fallen. These flows also have adverse consequences for holders of bond funds.
3. The fact that bond managers are motivated to out-perform the market on a total return basis has the potential for increased dangers of leverage, use of derivatives and excessive trading. Examples are cited of funds that have suddenly "blown-up".
4. Bond fund management fees are a large expense, typically 0.5% to 1.25%, which represents a large cost in a 6.5% interest rate environment.

These statements are in part misleading, in part naive, and, in very large part, incomplete. The net result is that they do a real disservice to individual investors.

There is no question of the opportunity for abuse in the management of any fund and it is a reason why the selection of funds is such a critical part of decision-making and why integrity of the management organization is an important part of the selection criteria.

By way of contrasting the trade-offs between holding individual bond securities versus holding bond fund, we would use a well known Bond Market Index Fund as an example of a typical bond fund, available to anyone. This Fund has over $12 billion in assets and its objective is to provide returns equivalent to the Lehman Aggregate Bond Index. The Lehman Aggregate Bond Index is 25% invested in US Treasury securities, 35% in mortgage-back issues, 25% in corporate bonds and 15% in other issues. It is representative of the universe of all bonds outstanding. The Vanguard Bond Fund charges 18 basis points (0.18%) of expenses to investors who participate in it.

So what do you get by investing in the Vanguard Bond Index Fund versus holding individual bonds?

1. You do not get a 'fixed maturity date', but instead get 'managed duration.' What's the difference? The fact that maturity is fixed is not necessarily a good thing. Having a bond mature when interest rates are low is adverse, just as maturity at times of high interest rates is beneficial. This is an example of an under-appreciated risk of bonds, "reinvestment risk', the risk that you will have funds to reinvest at an inopportune time. In the 1980's many small investors were severely hurt by the fact that as they had to reinvest proceeds from their maturing CD's, their income declined dramatically because of the falling trend of interest rates. A bond fund manages

interest rate risk, reinvestment risk, and other bond risks (credit, prepayment, and structure) in a steady fashion against a benchmark.

2. The adverse flow of funds argument is specious. First, it is not at all clear that individual investors inherently make foolish decisions regarding interest rates. At times the rational management of gains and losses for income tax purposes comes into play, but for the most part individual investors are, and should be, buy and hold investors. But, to the extent there are extraordinary amounts of either deposits or redemptions from bond funds, it is a non-event to the funds. Bond markets are highly liquid and bond managers are able to rebalance their portfolios in a timely and cost effective manner as these flows occur.

3. The newsletter implies that it is bad that bond managers are evaluated on a total return basis and therefore are encouraged to take risks to achieve better results is also specious. Risk taking can be a good thing, and many managers have proven their ability year after year to add value with astute management of the bond portfolio. For the Vanguard Bond Index Fund this argument doesn't apply because it is an index fund. At the same time, holding a few individual bonds that are unmanaged and undiversified within a client's account strikes us as introducing significant risks of a very different kind.

4. As was mentioned above, the expenses for the Vanguard Bond Index Fund are 0.18%. There are other, actively managed and very highly rated bond funds that have expenses from 0.4% to 0.6%. While not trivial, these expenses are clearly reasonable for a well managed fund that offers broad based exposure to all segments of the bond markets and provides competitive returns.

5. Which gets at the ideas of performance and diversification, two items not mentioned in the newsletter. Unless an individual investor has at least $1million in bond assets, it is extremely difficult to create a well-diversified bond portfolio, especially one that invests in corporate, mortgage-back and asset-backed issues. Further, trading costs, both in the purchase and especially in the sale of bond holdings is exorbitant for individual investors, estimated by one study at being 2% one-way. This is because brokers have a difficult time placing small units of bonds, and because dealer spreads on bonds are invisible to the individual (and therefore prone to abuse). As a result of these considerations, unless there is the good fortune that the specific risk contained in holding a few bond issues out-performs the general market, an individual investors holdings of bond securities is likely to under-perform the general market, bear greater risks (whether duration, credit, convexity or reinvestment risk), and be either illiquid or liquid only with the price of high transactions cost.

Why anyone would wish to hold individual bonds other that perhaps some Treasury issues for clearly specified reasons is beyond us.