INSIGHTS

Individual Bonds vs. Bond ETFs

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Are investors better off purchasing a portfolio of individual bonds or investing in a bond ETF? The decision is less about which investment vehicle is better or worse and more about what your needs and objectives are as an investor.

Ultimately, what both vehicles have in common is they both provide access to the bond markets. However, Individual Bonds and Bond ETFs are two very different animals. Investors need to be aware of the significant differences between the two.

Preservation of Capital

A primary concern of many investors is the preservation of capital. Individual bonds allow investors to rest easy, knowing that their original investment will be returned as long as the bond is held to maturity (without default or call, with callable issues). Bond ETFs, on the other hand, do not have a stated maturity date, so there is no point at which the investor is assured to have the same amount of money that was originally invested.

Diversification

Most bond ETFs serve an important function – convenient diversification. When investing in lower credit quality bonds where event risk is a significant concern, broad diversification is particularly important. However, when considering an investment-grade or high-grade bond investment, the advantage of individual bonds over bonds funds is clear. Most investors, even with a modest amount to invest, can achieve sufficient diversification through self-directed bond investments by taking advantage of the wide variety of corporate medium-term notes, agency debentures and bank CDs available in $1,000 denominations.

Liquidity

Bond ETFs are a relatively new entrant to the market. iShares launched the first version in 2002. Bond ETFs operate much like closed-end funds, in that they are purchased through a brokerage account rather than directly from a fund company. Likewise, when an investor wishes to sell, ETFs must be traded on the open market—meaning that a buyer must be found because the fund company will not purchase the shares as they would for open-ended mutual funds. ETF investors have an expectation of instant liquidity, as in company stocks on an exchange. The problem, however, is that the underlying securities in the ETF have no such liquidity. Like stocks, ETFs trade throughout the day. Extremes in price fluctuation have been seen during market anomalies, such as the so-called Flash Crash. While significant deviations in value are relatively infrequent, they are not unheard of. Deviations may be of particular concern during crisis periods, for example, if a large number of investors are seeking to sell bonds all at the same time. In the face of large liquidations, most ETFs have mechanisms in place to limit withdrawals. In a retail-dominated sector, finding willing buyers in a 'fire sale' is more difficult when institutions aren't a significant player. It may become a situation where liquidity is only present when you don't need it, but disappears when you need it the most.

ETFs may present serious liquidity concerns if interest rates begin to rise and investors experience principal losses and exit the market, as there is no fixed maturity and return of principal in an ETF. It is a pooled investment vehicle, not a bond.

Bonds Are Fully Invested

In terms of income generated, bond ETFs differ from individual bonds in several ways. In order to facilitate redemptions, fund managers are forced to keep a portion of their portfolio in cash or money market instruments at all times. In effect, they can never be fully invested in the market, which serves as a drag on performance over time. In addition, fund managers are forced to buy or sell bonds, often at inopportune times, because of net flows in or out of the fund, or simply to keep the portfolio’s duration balanced to its target. This causes the income generated by the portfolio to fluctuate from one period to the next. With individual bonds, the investor’s money can be fully invested to produce a consistent and predictable stream of income over virtually any investment horizon.

Income Generation

An investor who purchases an individual bond knows the yield to maturity he or she will earn at the time of purchase. This is because both the income to be received and the value at maturity are known in advance. With a bond ETF, neither can be predicted at the time of the investment. Changes in interest rates over the entire holding period, as well as the strategy employed by the fund's manager, are the primary drivers of fund performance. In a way, bond ETFs take the "fixed" out of fixed-income. Their purpose is not to provide a predetermined income stream, but rather to make a bet on both the future performance of the fixed-income market and the investment choices made by the fund manager.

Predictable vs. Surprise Tax Consequences

In addition to the unpredictable income stream discussed above, bond ETFs may also make end-of-year capital gains distributions. Aside from the obvious nuisance such unexpected disbursements can cause, they may also result in undesirable tax consequences for certain investors. Quite simply, the fund manager's decisions can't possibly be made with the unique tax considerations of each investor in mind. With individual bonds, the future cash flows and their tax consequences can be anticipated and planned for in advance. Individual bond holders can take advantage of tax losses in the portfolio, many times without taking apart the investment strategy.

Summary

Most bond ETFs offer convenient diversification for most retail investors. For high net worth and institutional investors, this is typically less of an issue. The principal investment required to achieve sufficient diversification of individual bond portfolios will vary depend on the strategy. Government and high grade corporate portfolios require a smaller number of bonds where high yield portfolios require significantly more bonds to achieve sufficient diversification. ETFs may present serious liquidity concerns relative to individual bonds if interest rates begin to rise and investors experience principal losses and exit the market, as there is no fixed maturity and return of principal in an ETF. It is a pooled investment vehicle, not a bond.

When deciding between a bond ETF or individual bonds for investors with a modest amount to invest, the simplicity of bonds – with their known price, known yield, known maturity, and lack of ongoing expenses - offer fundamental distinct advantages over bond funds.

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