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The Safe Haven of Bonds Made Riskier by ETFs.

Bonds have always appealed to conservative investors looking for a safe place to park some money while still receiving a steady and predictable return.

Yet a growing number of investors are steering away from buying individual bonds due to the research required and the high cost of diversifying a portfolio. Instead, they are putting their money in bond exchange traded funds, which invest in many bonds.

Some financial advisers believe that might be a riskier move.

The value of a bond ETF goes up and down throughout the trading day like a stock and can be traded like a stock. Investors also could lose their principal.

"The challenge with bond ETFs is you are buying the debt in a bond ETF with little regard to the creditworthiness of the underlying bond issuers," said Matthew Helfrich, president of Waldron Wealth Management in Bridgeville.

"If you have bond issuers who are already drunk on debt, you could — by buying their ETF — be giving them another drink."

What makes bond ETFs more risky than individual bonds, which typically sell for a par value of $1,000 each, is that individual bonds have a fixed date at which they mature and investors get their $1,000 back.

Bond ETFs never mature because additional bonds are continually being bought and sold, therefore they can never offer the same protection for an investor's initial investment.

And just by investing in the exchange traded fund, investors can be reducing the issuer's creditworthiness, Mr. Helfrich said, adding that investors are adding money to a pool of funds that will be used by companies that may not be as creditworthy as buyers would prefer.

"Bond ETFs can be worthwhile for broad exposure to the bond market and the flexibility to trade, but you have to know exactly what you are doing," Mr. Helfrich said.

With the Federal Reserve on course to continue raising interest rates for the foreseeable future, fixed-income investments, such as bonds, will be vulnerable. As interest rates rise, the value of existing bonds paying lower yields will fall as new bonds paying a higher yield gain value.

But owners of individual bonds will still receive all of their principal when a bond matures, regardless of how high rates have climbed.

The risk of losing money has not stopped investors from embracing bond ETFs. Data from the Washington, D.C.-based Investment Company Institute show the total net assets in bond mutual funds and bond exchange traded funds grew from $57 million in 2008 to $490 million as of May 2017.

“The good news is that bond ETFs provide diversification, which is crucial. But the bad news is there are hidden landmines in bond ETFs … ,” said Andrew Stoltmann, a securities lawyer based in Chicago. “It’s very hard to do your due diligence on the quality of the bonds inside the bond ETF because there are so many.”

The same advantages and disadvantages apply to bond mutual funds, which are actively managed and often charge higher fees than bond ETFs.

Bond ETFs, which charge expenses of less than a half a percent, have grown at a significantly faster rate than bond mutual funds, which usually charge fees of about 1 percent.

Bond ETFs, like bond mutual funds, come in a variety of flavors from treasuries to municipal and corporate bonds. Both pay regular dividends to investors. In addition to being cheaper, bond ETFs are more tradable and often more transparent than bond mutual funds.

Pittsburgh financial adviser Robert Fragasso, chairman and CEO of Fragasso Financial Advisors, Downtown, said his firm uses bond ETFs in client portfolios while recognizing that all of them are not created equal.

Many exchange traded funds will disclose to the public their holdings every day, in addition to the quarterly disclosure required for all mutual funds.

The challenge, Mr. Fragasso said, is that there could be dozens of bonds in an ETF with varying maturity dates and credit qualities, which require portfolio managers to devote considerable research before selecting a fund for clients’ portfolios.

“The future value of a bond ETF is contingent on knowing the dynamics of the bonds inside the ETF,” he said. He said investors need to understand the maturity or the credit quality of the bonds in the fund.

“So, later on when they’ve lost 20 percent of the value of the investment, they will cry that it’s a lousy product when in fact the fault lies squarely on the buyer who didn’t understand what they bought,” he said. “There are hundreds of bond ETFs out there, all with different profiles and different purposes. The [average retail buyer] is usually unaware of the differentiation.”

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