The Pros and Cons of 'Target Maturity' Bond Funds.

These new products combine the benefits of a traditional bond fund with a fixed maturity date. They have their critics.

There's a new type of bond fund that aims to solve a shortcoming of traditional bond funds. But the jury is out as to whether they are worth buying.

Bond funds offer investors broad diversification, professional management and regular income—benefits tricky to achieve with a collection of individual bonds. But they also have a downside: no fixed maturity date. Investors can't simply wait out a downturn, knowing the price will move toward face value as maturity approaches, as they can with an individual bond.

To address that perceived shortcoming, some fund providers in recent years have introduced a hybrid product offering the benefits of a traditional fund plus a fixed maturity date. Though some experts disdain these "target-maturity bond funds," others say they can be a good choice for some investors in today's volatile market, especially those looking for steady income and a return of principal for an expected need—such as paying for college, buying a home or starting retirement.

"In today's market, these target-maturity funds are especially appealing," says Jay Srivatsa, chief executive officer at Future Wealth, a wealth-management firm in Los Gatos, Calif. "It takes the volatility and randomness out of the equation and, most importantly, takes out the investor's emotional reactions to the stock-market gyrations. Knowing that X amount will be available on year X gives peace of mind."

Target-maturity funds are easier to research and purchase than individual bonds, he says, and they appeal to investors who don't want to face long-term interest-rate risk.

Older investors may find this option worth a look in today's environment, says Ankur Patel, vice president at Lenox Wealth Advisors' New York office.

"As we continue to see baby boomers enter retirement, an entire generation of investors will be looking to reduce risk, generate income and invest more in bonds," he says.

How they work

Investors who buy individual bonds know that, barring a default, they will receive a predictable income and a return of principal on the maturity date. Earnings in bond funds are less predictable because the fund must constantly buy and sell individual bonds to maintain an average maturity promised investors.

That means the fund can suffer a loss if it must sell bonds when prices are down. That's because rising rates drive down prices of older bonds that pay less than new ones. While falling rates can lift bond prices, they can be harmful if the fund must replace older bonds with new ones that pay less, reducing the fund's yield.

Target-maturity funds—not to be confused with target-date funds, which gradually shift assets from stocks to bonds to increase safety as the target date approaches—tackle these problems by purchasing bonds maturing at about the same time. When the fund's maturity date arrives, the fund closes and investors receive their principal just as they do with individual bonds, though the amount isn't guaranteed up front and can be subject to market conditions. Income is relatively dependable—but, again, not guaranteed—because the fund doesn't need to replace holdings along the way.

The two big players are Invesco, which offers a series of BulletShares corporate and emerging-markets "defined maturity" exchange-traded funds maturing every year from 2018 to 2028, and BlackRock Inc.'s BLK 0.42% iShares, which has corporate and municipal bond ETFs maturing from 2020 to 2028.

Fees are modest, typically below 0.5%, though that can add up over time. Of course, an investor owning individual bonds would have no annual fees. Investors also face commissions on ETF trades, though that can be minor for the buy-and-hold investor these funds are designed to serve.

Critics weigh in

Despite their appeal to some, these funds do have critics. "I do not typically recommend target-maturity bond funds because their annual costs are significantly higher [than index bond funds] for a buy-and-hold investment, and there is a lack of flexibility," says Debra Taylor, founder of Taylor Financial Group, a wealth-management firm in Franklin Lakes, N.J.

"The benefit is that the funds are packaged up in one place, and they do provide diversification for the smaller investor," she says. "However, the more-sophisticated investor may be better off purchasing the individual bonds and creating their own ladders." (A ladder is an assortment of bonds with various maturities.)

Most experts seem to agree that these funds are best for investors with an expected cash need at the maturity date, rather than those who will reinvest. The principal may be returned at an inconvenient time for reinvestment—when yields are low, for instance. Because the fund won't replace its holdings, you can't expect the fund yield to rise as rates go up, as it would with an ordinary fund that gradually adds new bonds that pay more.

In today's market, many experts recommend funds with short maturities of under three to five years, since longer-term bonds don't currently pay enough extra to justify their greater risk.

Young people with long investing horizons are especially unsuited to these funds, Ms. Taylor says, because they can ride out bond-price dips. With maturities out to only 2028, target-maturity funds serve investors who expect to need their money in 10 years or less.

Dennis Shirshikov, a financial analyst at FitSmallBusiness.com in New York, warns that many bonds in these funds will mature months before the fund closes, leaving cash to sit idle. And Mr. Patel of Lenox Wealth Advisors says investors should expect fund yields to drop in the final year to the level of bank savings. Also, many of these funds own bonds that can be called early, worsening the problem of cash buildup even before the year of maturity.

Getting out early

Investors also should know that they can lose money if they unload one of these funds before maturity. That could happen if rising rates drive down bond prices. Also, since these ETFs are traded like stocks, there's no guarantee an investor will find a buyer if he or she wants to get out early, though experts say lack of liquidity hasn’t been a serious problem.

“These are generally not a great short-term trading option,” Mr. Shirshikov says. “In fact, you will likely be better served with other bond products if you are interested in trading on bond volatility or interest-rate movements.

“However, if you are considering locking your money away in a CD or purchasing government bonds with set maturity with the hope of taking the money out at a later date and earning some interest in the process, this is a great product to invest in,” he says.

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