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When Bond Funds Make Sense.

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Like mutual funds and exchange-traded funds, bonds and bond funds can help investors take the edge off market volatility and create a balanced, diversified portfolio. But a debate rages among people who worry about this stuff: Is it better to own individual bonds or bond funds?

The benefits of bond funds

With an individual bond, you get 100 cents on the dollar when it matures (assuming the issuer doesn't default). The knock on bond funds is that, because they are constantly buying and selling bonds, they have no maturity date. Therefore if rates are rising, the value of the fund goes down, and you might have to sell the shares for less than you paid.

While this criticism of bond funds is accurate, there are quite a few caveats. For starters, you'll need at least $500,000 in the bond portion of your portfolio to achieve sufficient diversity and the scale to absorb transaction costs. Short of that, you're better off in funds.

What's more, a bond fund can take advantage of rising rates by constantly buying bonds with higher coupons. But say you own a $10,000 bond paying 3% interest and rates rise to 4%. The semi-annual payouts of about $150 won't be enough to buy a new, higher-yielding bond.

And finally, while it's true you will get your money back if you hold a bond to maturity, you still suffered opportunity cost – you were unable to invest that $10,000 in a new, higher-paying bond without selling and taking the loss.

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