[Bond Case Briefs]

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[As Bond Yields Plunge, the Case for Owning Individual Bonds Over Funds Grows.]

If you have a client with a goal to earn a specific level of income every year, how does it look when the payout on her bond funds declines with interest rates? Or, what if interest rates rise, and the fund's value drops instead?

For these reasons, some advisors favor buying individual bonds for clients instead of bond funds. Now seems a particularly compelling time to employ this strategy.

Rates on most bonds are so low that finding safe individual ones that yield a little extra that you can hold until maturity makes sense, especially if rates kick back up again. (Bond prices move inversely with rates so that existing bonds' yields can match those of newly issued ones with higher payouts.) That way, an investor won't lose any principal.

Year to date the average bond fund in Morningstar's popular Intermediate Core Bond category is down 0.6%, while the Long-Term Bond category is down 0.8%. That isn't appealing for investors seeking a steady fixed payout and return of their principal at their goal's end date. "Interest rates are near all-time lows, but a bond fund is a bet that interest rates will fall," says Stan Richelson, a Bluebell, Pa.-based advisor and co-author of Bonds: The Unbeaten Path to Secure Investment Growth.

Richelson and his wife Hildy — his fellow advisor and president of Scarsdale Investment Group — often buy individual municipal bonds with high credit ratings for clients and ladder their portfolios by holding issues of different maturities. That way, if rates rise as bonds with shorter maturities mature, clients get their principal back and it can be reinvested in new bonds with higher yields. They generally hold bonds until maturity so there is no potential for a loss from a rate shift, like in a bond fund. Because they're buy-and-hold investors, they also don't encounter the trading costs of mutual funds buying and selling bonds constantly as new money flows into a fund or old money exits.

Many clients also like the transparency and consistency of buying individual muni bonds, especially from their home state where they can get not only a federal but a state tax exemption. By contrast, many single-state funds only invest in the largest states like California and New York and often aren't the purest or safest plays in those states. "If you looked at these single-state funds, you'd never buy them now because they have huge numbers of low-rated bonds," Richelson says. "In the past, they were loaded with Puerto Rico [which defaulted on its debt] and Virgin Island bonds because they had a tax exemption, like the same state."

Building a bond portfolio requires more time and research than buying a single fund. The Richelsons have invested in individual bonds and written about bonds for some 30 years. The less experienced may require outside help. "It's way easier just to put somebody in a bond fund or an ETF," says advisor David Haverstick at Ables, Iannone, Moore & Associates, which has built individual bond and stock portfolios for clients since its founding in Savannah, Ga., in 2003. "You can click the button and be done with it. For us, we think the specific [bonds and stocks] that we can bring to clients' portfolios is where our value is. But you have to have time, and the resources to be able to do that," he says.

Despite his experience, Haverstick still relies on outside research and analyst reports to pick primarily individual corporate bonds for clients. Though he won't disclose his analytical sources, free bond research is available at most brokers and more detailed research can be bought from ratings services like Moody's Analytics and S&P Global Ratings.

The main concern with an individual bond portfolio is default or credit risk since such portfolios generally aren't as diversified as funds. Although Haverstick doesn't have a standard bond account size, he says the larger the better, since a portfolio can diversify into more bonds. As for Richelson, he says the high-quality muni issues he generally buys—which are often state issues or general obligations, as opposed to local revenue bonds dependent on a single project, such as a hospital's or school's finances—telegraph problems well in advance of a potential default. For instance, he sold out of Illinois municipal bonds seven years ago, based on its history of problems funding government employee pensions. Only in 2020's pandemic did the state's debt get downgraded to near-junk-bond levels.

Moreover, because states have the ability to raise taxes to pay debts, defaults have been rare. Since 1970, the default rate for high-quality or investment-grade muni bonds has only been 0.1%, versus 2.3% for similarly rated corporate bonds.

If picking bonds is too much work, one alternative is to invest clients' assets in a private account of individual bonds run by a professional money manager. For instance, Pimco, one of the world's largest bond fund managers, also runs private accounts for high-net-worth investors in its Global Wealth Management division, which oversees $381 billion (as of March 31). The minimum account size to build a basic muni or corporate bond ladder is $150,000 but as high as $1 million for more active strategies, says Mark Thomas, an account manager at Pimco's Global Wealth Management group. "The minimums are important, because we need to make sure that we get access to a diversified pool of assets," he says.

Outsourcing adds an extra layer of fees for clients. How much depends on the level of account customization. "Fees are commensurate to the work we're doing," Thomas says. If the account is a buy-and-hold bond ladder, fees "generally compare pretty well to ETFs, and on the active [bond] account side, they would be comparable to our active mutual funds."

In other words, if clients want individual bond portfolios, there are competitively priced solutions.

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