Investing Perspective: Bonds and Bond Funds

I have been calling this section "Stock Market Perspective," but that does not seem appropriate for this issue's discussion. A few of the past ones have only been tangentially linked to stocks, so the above is a better, more inclusive, title for this section.

Most investors find bonds to be less interesting or exciting than stocks. Such is not surprising because bonds generally do not fluctuate as much as or make the news as frequently as stocks. However, bonds and fixed-income investments make up a significant part of many (most?) investors' portfolios. You may be surprised to hear that there are more assests in fixed-income investments than in equities—stocks and funds that own stocks.

Can an ETF provide the advantages of both individual bonds and bond funds without their disadvantages?

Individual investors hold well over half of their equity holdings in mutual funds including exchange traded funds (ETFs). Nearly all if not all 401(k) and similar retirement plans do not permit holding individual stocks. Consequently the equity holdings, which typically have the bulk of the assets, are in funds, usually regular mutual funds since few 401(k) plans allow ETFs.

In contrast, individuals own more bonds directly than through bond funds. I have seen data that excluding money market funds individual investors own $1.8 trillion of bonds and have just $1.5 trillion in bond funds. Direct ownship of bonds often has signficant advantages when compared to bond mutual funds and ETFs. Some ETFs that started a few years ago try to provide the advantages of both direct ownership of bonds and of funds without the disadvantages of either. They have met those goals fairly well for individual investors.

Those ETFs are the BulletShares® ETFs from Guggenheim Investments[1]. The first ones started in 2010, and new ones are introduced periodiacally. Before digging into them, I will first discuss the advantages and disadvantages of direct ownership of bonds and of bond mutual funds.

The most important feature of directly owning a bond is the certainty provided by holding it to maturity. Assuming the issuer is able to pay off the bond when it matures—one reason Treasury bonds are popular, the amount of money to be received in the future is known. (Some bonds, but virtually no Treasuries, have a "call" provision that allows the issuer to redeem the bond before maturity after a specified date for more than its face value. If that happens, the holder of the bond then faces the problem of how to reinvest the proceeds.) Moreover, the amount of income paid periodically by a bond is known and can be incorporated into financial plans. Traditional bond mutual funds and ETFs lack both of these advantages.

Among the advantages funds have over direct ownership are diversification, professional management, and being able to (except for buying Treasuries directly from the government) buy and sell them any day the market is open without having to worry about liquidity and bond dealers' bid-ask spreads. The amount of income from a fund likely will vary over time, and the fund's value likely will move in the opposite direction of interest rates. One could plan on selling the fund at particular date, but there is no

[1] Guggenheim now owns Rydex funds, and I have traded Rydex funds in personal and managed accounts for more than 15 years. In that regard, I have occasional contact with their personnel and information not available to the general public, some of which is incorporated here. However, I do not receive any compensation from Guggenheim or any of its subsidiaries.

assurance that the amount received will be at least what was paid for the fund. A bond held to maturity will pay a known amount. In other words, funds reduce the risk from owning non-Treasury bonds through diversification and professional management, but they are subject to fluctuations from rising or falling interest rates unlike a bond held to maturity. If a bond needs to be sold before maturity, it is subject to interest rate risks, and may be difficult to sell at a reasonable price.

BulletShares ETFs are based on the simple idea that the fund can own a portfolio of bonds that all mature in the same year. At the end of the year the fund will cease to exist and its assests, which will all be in cash, will be paid out to its holders. That behavior is virtually identical to an individual bond maturing. There are some details and technicalities involved in this approach, and I will next discuss some of them.

The most basic consideration is what types of bonds and which individual bonds should be owned by each ETF. There are two types of bonds owned by BulletShares ETFs: investment grade corporate debt and below investment grade high yield, sometimes called "junk," ones. The specific bonds to be owned by the funds are determined by indices maintained by NASDAQ and formulated by Accretive Asset Management. Consequently, Guggenheim does not have to decide which bonds to own and when to buy or sell them. One result is that the expense ratios are fairly low as is typical for ETFs: 0.24% for the corporate funds and 0.42% for the high yield funds.

Except in the maturity years, 2014 currently, the funds hold over 100 bonds and some of them own more than 200. To guage the quality (risk level) of the holdings, the 2020 corporate fund has about 85% of its portfolio in A and BBB rated securities. Those are the two lowest "investment grades," and the remaining 15% is just about all in AA with a small portion in AAA, the highest rating. In contrast, the 2020 high yield fund is about 44% in BB, just below investment grade, another 44% in B, and remainder in the lower grade, junk (i.e high risk of default) grades. As we know, taking on the additional risk requires a higher potential return. The 2020 corporate fund recently had a yield to maturity, the best measure of the longer term return, of 2.87% compared to 5.24% for the high yield one for the same maturity year.

The composition of the indices will vary over time due to events such as bonds being called, ratings increases or decreases, or defaults. When a bond is removed from an index, it will be replaced. Due to the way yield to maturity compuatations work, the replacement will not affect those of current fund owners. Even if prevailing interest rates have changed quite a bit in the interim, the yield to maturity when the fund was purcahsed will stay the same after the portfolio is adjusted assuming the fund is not sold before its maturity year.

The bonds owned are chosen so that they mature over the whole last year, not just in one or two months. For those that mature early in the year, the fund will hold short-term debt instruments, and in the last half of the year the proceeds of the maturing issues will be held in cash or equivalents. A holder of one of the ETFs in the maturity year can either sell it or wait for it to be liquidated at the end of the year.

As is the case for all ETFs, shares can be created or redeemed by an exchange of the holdings in the index for shares of the ETF or in the other direction. Because there are no exchanges for bonds as there are for stocks, dealing with a large number of bonds is not as easy as with stocks. Consquently, the difference between the price of the ETF and its net asset value may become larger than is typically the case for ETFs that own stocks. The price when buying or selling these funds may be higher or lower than the true value of the fund, perhaps by as much as a percent. Like other ETFs, there is a bid-ask spread when buying or selling one. The spreads for the BulletShares seem reasonable, two or three cents on issues priced in the $20 to $30 range. (The highly liquid ETFs such as the S&P 500 "spiders" (SPY) usually have a spread of a

penny on shares priced almost at $200, which is essentially meaningless.)

The BulletShares can be used in portfolios as bonds would be. One example is in a "ladder," holding several maturity dates, say 2015, 2017, 2019, and 2021 with a plan to use the proceeds of the 2015 payout to buy 2023 shares. (Currently, the longest dated shares mature in 2022 for the corporates and 2020 for the high yields. Later maturities are being introduced.) Another common use of individual bonds is to provide funding for a specific future event such as college tuition for a child or grandchild or for retirement. If one does not already own individual bonds, these ETFs may be a better and more efficient way to construct a ladder or provide future funding.

Like other ETFs, the BulletShares should be tax efficient because the creation and redemption of shares enables the fund managers to arrange the transactions in a way that reduces or eliminates capital gains to the funds' holders. The income paid out by the funds will be taxable if not held in retirement type accounts.

Am I planning to own these shares in the accounts I manage? Not as things stand now. I do have a model for trading medium to longer term Treasury securities, and I have traded ETFs that own these in Tactical Asset Allocation (TAA) accounts. Even if one wants to trade based on anticipated changes in interest rates, there are much better ETFs to do that. The best way to own BulletShares is to buy them and hold them until the maturity year.

A client who wants to explore putting some of these bond alternatives into the portfolio without trading them should get in touch with me. We can discuss the yields and maturities available and how they would apply to investment objectives. I also can provide more information and documents that go into more of the details about these innovative funds.