

Individual Bonds vs. Bond Funds

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Bond investments can be made two ways: buy shares in bond funds or buy individual bonds.

Both methods are designed to provide the investor with steady income. Both of their market prices move in the opposite direction of interest rates. Both tend to provide diversification away from the stock market.

Which is better? We believe that, for most investors, bond funds offer at least 10 advantages over individual bonds. We agree that individual bonds possess two advantages. First, mutual funds carry a management fee and bonds do not; though there is a bid/ask spread and commission when you buy and sell the bond. Second, each individual bond provides certain return of principal on the maturity date so long as it does not get called early and does not default. A bond fund has no fixed maturity date, so it cannot guarantee return of principal upon maturity.

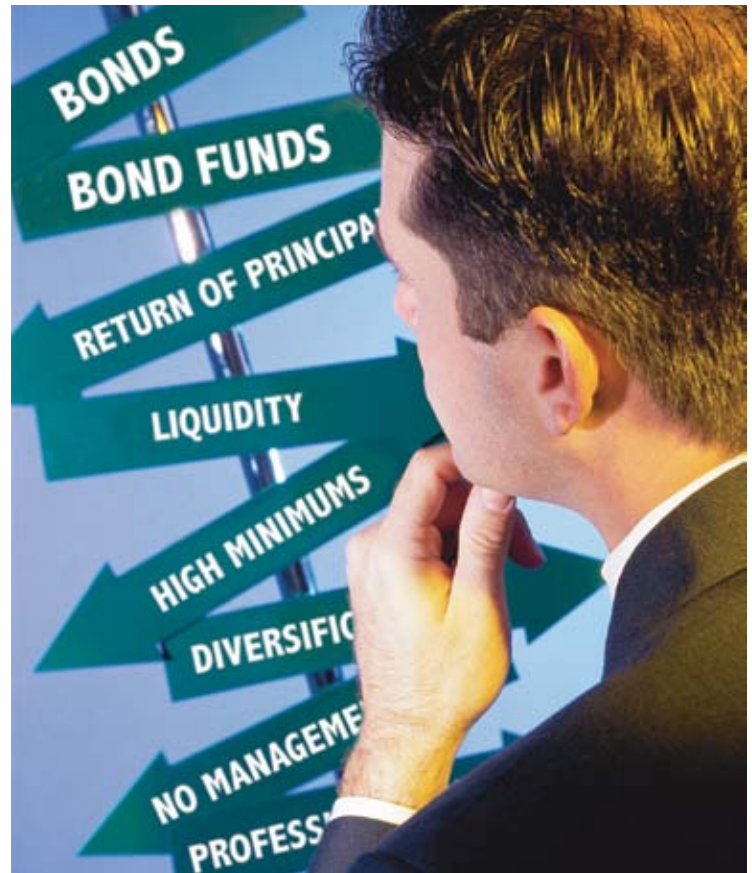
This second advantage is for a single bond only. If you own a set of bonds with various maturities, you have certain return of principal over many years, but not on any given day. Bond funds hold many bonds and constantly purchase new bonds as old bonds mature, so like a portfolio of individual

bonds, a bond fund never matures on a single day. Under real world circumstances, the difference between a portfolio of individual bonds with varied maturities and a bond fund portfolio is small - neither guarantees all your money back at par on any single day.

Note the flaws in the advantages for individual bonds. On small orders (block size less than \$100,000), bid/ask spreads are often sizable. For the municipal bond market, an entire web site, www.municipalbonds.com, exists solely to document instances in which brokers take abnormally large mark-ups on odd-lot bond trades. This indicates that it is not uncommon for retail investors to sell their bonds at low prices and buy bonds at high prices.

What are the advantages of bond funds?

1. Liquidity. Shares in a bond fund can be redeemed every business day at net asset value (NAV), in any quantity. (When redeemed, the value of fund shares may be worth more or less than the original cost.) In contrast, individual bonds trade in an over-the-counter market with inconsistent liquidity. Bonds trade in a choppy market, more like real estate than like stocks. Once



you own a bond, the only way to cash out before maturity is for your broker to solicit bids. The price you receive is whatever the buyer offers, less the broker's bid/ask spread or commission. As with a bond fund, an investor may lose money when selling an individual bond.

2. Low minimums. Most bond funds have a \$5,000 minimum and allow additional share purchases of smaller amounts. Individual municipal bonds are technically \$5,000 each, but in reality usually trade in amounts greater than \$25,000.

Any individual bond trade smaller than \$1,000,000 is considered an "odd lot," subject to higher mark-ups.

3. Diversification. Bond funds offer diversification, which helps limit risk. Say you want to build your own diversified bond portfolio using blocks of \$50,000. To avoid having any one bond be greater than 5% of the total, which is a typical single-largest exposure for a registered bond fund, you need a portfolio of at least \$1,000,000.

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4. Professional management. Bond funds offer the service of professional portfolio managers. You pay management and operating expenses, and in return a portfolio manager, traders, and credit analysts identify and purchase bonds suitable to the fund's risk/return strategy. You can select a bond fund to fit your preferred strategy, credit quality, average maturity, etc. The portfolio managers monitor each of the bonds and the overall portfolio to ensure that it performs as expected.

5. Bid/ask spread. Since millions of different bonds trade in an OTC market, the bid/ask spread is wide. Retail investors are often on the high (ask) side of the spread when buying individual bonds. But bond funds strive to purchase bonds in the bid (low) market (to buy as high bidder) and to sell in the offer market (to sell to the highest offer).

6. Funds are simpler. It's much less work to buy shares in a bond fund, and after you buy it, you can have dividends automatically reinvested to purchase additional shares. However, to craft a good portfolio of individual bonds takes considerable time and effort. Once you assemble a portfolio, each bond pays a twice-yearly coupon. Many investors may allow their coupons to sit in a low-yielding money market fund for long periods.

7. Funds can be purchased in various dollar amounts. Say an investor has \$45,500 to invest, or \$232,300, or \$419,650. It would be difficult to find an individual bond in those exact amounts. Remember that a bond's purchase price reflects its block size, any premium or discount, and accrued interest. The investor may search the market for an extended period, settle for whatever becomes available, and leave excess cash

uninvested. With a bond fund, the investor can invest any amount instantly (Thornburg Funds have a minimum investment of \$5,000 for A shares to open an regular individual account).

8. Performance rankings. Bond funds are evaluated for risk and return by independent companies like Morningstar. Investors can use that research to compare funds. Performance evaluations are possible because bond fund NAVs are priced daily, giving Morningstar a basis for performance evaluation. Most individual bonds have credit ratings, but no performance rankings.

9. You know your account's value. Individual bonds are not marked-to-market daily, so you don't know how much your bond is worth until you ask for one or more current quotes. Bond fund NAVs, on the other

hand, are marked-to-market every day the bond market is open. To learn exactly what your shares in a bond fund are worth, simply look at your account statement, check the newspaper, or call the fund's customer service department.

10. Funds offer flexible investment and redemption options. Many fund companies give shareholders a wide berth to maneuver their investments. Fund companies give different options to redeem funds – in writing, by phone, online, in person – and various options to receive the proceeds by check or wire or transfer. Most fund companies offer exchange privileges among their family of funds. Often dividends of one fund can be reinvested into a different fund. ■

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

Bid/Ask Spread – The the difference in price between the highest price that a buyer is willing to pay for an asset (the “bid”) and the lowest price for which a seller is willing to sell it (the “ask” or “offer”).

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Investments in the Funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in the Funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read it carefully before investing.

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