Myth Busting: Individual Bonds - Transcript

Brendan Mullooly: On episode 86, we're going to talk about bond funds versus individual bonds.

Welcome to the Mullooly Asset Show, I'm your host, Brendan Mullooly. Got a good question today. Tim, what are we going to be talking about?

Tim: With interest rates rising, I've heard owning individual bonds is safer than owning bond funds. Is this true?

Brendan Mullooly: That's a good question. Not surprised to get it with the way interest rates have been lately. So I just want to start with one thing I always like to say about investing and it's that when we talk about safer, in this question, safer is very subjective when it comes to investments and when we're talking about risks, we're talking about making trade-offs. So we're never getting rid of risk entirely, that's not possible. We're talking about trading one risk for another risk, or a set of risks. And in this case, the primary risk that we're discussing is interest rate risk. And so interest rate risk is that bond prices and interest rates move in the opposite direction of one another. So when interest rates are moving up, bond prices move down, and vice versa.

So the point being here that you could hold an individual bond to its maturity date and get your money back at the end. And that you cannot do the same exact thing with a bond mutual fund or ETF. And so little explanation of what a bond fund is, a bond fund is just a collection of individual bonds, but it's held together in a portfolio, usually has an average maturity, but there's never a point in the future where the entire portfolio comes to maturity and you get your money back. It exists in perpetuity, you have a constant exposure to bonds and as individual bonds come off the books for the bond fund, it's re-investing into new bonds over time.

So the interesting thing here is that interest rate risk exists for individual bonds and bond funds alike. There's no escaping it, interest rates affect bond prices whether you own one bond or a group of many bonds. But the difference I guess is more psychological? So, the investor in this sense is saying that with an individual bond, knowing that there's an exact date in the future where it comes to maturity, they're willing to ignore short term losses because of that comforting fact that in the future they can do that.

So my argument kind of is that, if you're willing to do that with an individual bond, you could do the exact same thing with a bond fund, because it's just a group of individual bonds. I think that the psychological benefit here comes obviously at a cost. And so we talked about trading risks for one another at the beginning of this episode. So what you're trading here is with the individual bond you do have that date in the future where you can get your money back at maturity, but you're probably far less diversified than what you would be in a bond mutual fund or ETF. Many of these funds, bond funds, own thousands of bonds, so if any of the issuers who's bonds you own default on them, which is a realistic possibility depending on what type of bonds we're talking about here, it's not going to be as important as if the one issuer of the one bond that you own defaults. In that scenario you're just out of luck.

Additionally, owning individual bonds is prohibitively expensive for most average investors. They trade by appointment, so you're probably getting killed on a spread where you don't even know the cost you're taking on by owning the bond individually. The bond fund is going to do this for you, it's going to own thousands of bonds, and it's going to trade them on your behalf. It's a lot simpler and for most investors I think it's going to be the way that they want to own bonds, in a diversified, cheap bond fund.

But again, good question and one that comes up a lot. Probably has a little more nuance than even we've discussed today, but I think that's a simple enough explanation. So we will see you in the next episode, which will be number 87.