Municipal Market Insight
Focus Article

Wealth Management

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Individual bonds versus bond mutual funds

Individual bonds and bond mutual funds each have advantages and disadvantages. But for many investors, we believe there is one overriding factor that tips the scales in favor of individual bonds—control. Holders of individual bonds maintain full sway over their financial assets and have the freedom to choose when and what to transact. Mutual fund investors, on the other hand, are subject to potentially adverse investment and tax outcomes driven by other investors' decisions to buy into or sell out of the fund.

The basics

Fixed income investors may choose to build their own portfolios by buying a series of individual bonds, or they may purchase bond mutual funds that pool cash from investors and purchase fixed income assets. Some mutual funds have relatively narrow investment profiles, while others have managers with wide latitude. But nearly every fund is compelled to invest most investor moneys into permitted investments in order to maximize returns. When money flows in, the mutual fund is incentivized to purchase market-available bonds—even if their yields are sub-optimal or outright unattractive—because remaining in cash lowers the fund's reported performance. Conversely, when money flows out, the mutual fund is required to sell assets for whatever the market is willing to pay to meet redemptions, or draw upon external liquidity, if available. These decisions are not made at the discretion of the fund manager, but are determined by net fund flows.

Market dislocations and the herd effect

Mutual funds have many characteristics that can benefit investors, but these qualities may be overshadowed during market volatility because of the potential forced selling driven by fund flows. Typically, when financial markets experience instability, skittish investors withdraw enough money from the markets to create net outflows. As a result, mutual funds are forced to liquidate holdings into a disordered market to meet redemption requirements, regardless of whether the fund was otherwise well positioned. Consequently, investors exiting the fund and those who remain are likely to realize net asset value (NAV) declines and associated tax consequences.

Forced selling by bond mutual funds can be particularly harmful during more extreme market dislocations, when bond prices often drop precipitously to

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attract buyers. Under these circumstances, price declines can be magnified for mutual funds because they typically must transact a large number of bonds in a short period to meet redemptions. Unfortunately, all owners of the mutual fund—not just the investors exiting the fund—realize the potential financial losses of these forced sales because mutual funds pool all investors' money. In effect, all mutual fund owners relinquish control to—and must accept the financial outcomes and tax consequences of—this herd effect.

Bond mutual funds are also a less efficient way to capitalize on mispriced securities during a market dislocation. When buying a mutual fund, investors cannot target only attractively priced securities, they are buying a proportional stake in the mutual fund's entire portfolio. When investors contribute new capital to their mutual fund positions during a market dislocation, the money is unlikely to be used to purchase attractively priced securities. Instead, if the fund is experiencing net outflows, these investors are simply paying the investors who are exiting the fund. Of course, mutual fund investors who add to their positions during dislocations are dollar-cost averaging, and thus ultimately benefit if the fund's NAV rebounds, but they lack the ability to precisely target the most attractive available bonds.

Bottom line

Bond mutual funds have many characteristics that can be advantageous for investors, including professional management and broad diversification for even relatively small investments. However, all mutual fund owners are subject to the herd effect of fund flows, which may cause undesirable investment and tax consequences. During extreme market volatility, net outflows may crystalize losses for all owners of a bond mutual fund at the worst possible time.

In contrast, individual bond owners can ignore the market volatility and potential price declines, confident that their full principal investment will be returned at maturity, absent a default. Individual bond investors' ability to choose when and what to transact may permit better investment and tax outcomes, and is the defining reason why we believe individual bonds are preferable to bond mutual funds for many buy-and-hold investors.

The table below is a non-exhaustive list of the pros and cons of individual bonds and bond mutual funds.

Comparison of individual bonds and bond mutual funds

	Individual bonds	Bond mutual funds
Income stream	Known at time of purchase*	Varies
Diversification	More difficult	Easier
Tax consequences	Controlled by investor	Subject to other investors' decisions
Realized losses*	Controlled by investor	Subject to other investors' decisions
Return of initial capital	Par at maturity*	Difficult to predict as funds don't mature
Credit monitoring	Varies	Varies; typically more robust
Transparency	Full	All positions typically not disclosed
Cost basis	For each bond	Price paid per share
Customization	Yes	No
Pricing economies of scale	Varies; typically less	Varies; typically institutional pricing levels

* Absent a default

Source - RBC Wealth Management

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