INTEGER WEALTH GLOBAL

The Difference Between Funds and Bonds

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The difference between mutual funds and bonds is that the former pools together the money of many investors to invest in a wide variety of bonds, whereas the latter are individual bonds that individual investors can purchase.

A bond represents a loan made to a company. A mutual fund holds a bunch of bonds.

A single person can own a bond. With a mutual fund, huge groups of investors pool their money, while the managers of the bond fund then choose the bonds the fund will buy using that money.

The idea of using mutual funds vs. bonds is that pooling money allows investors to spread their risk over lots of bond investments instead of just owning one bond.

What are bonds?

A bond is a loan to a company made by investors. Suppose a company issues $100 million of bonds and you buy $1 million of those bonds. The company owes you 1% of the total amount of money loaned..

Many public companies issue hundreds of millions or even billions of dollars in bonds over time, and individual investors can purchase these in lots of $10,000.

The price of the bond you own will rise and fall based upon other bondholders, and their desire to own or sell that bond.

The issuing price of a bond is called the “par value”, and it is usually issued at a par value of 100. That price will usually be fairly stable, but it may drop below that amount if there is concern that the company will be unable to make interest payments or pay off the principal.

What are mutual funds?

Mutual funds are baskets of bonds. A mutual fund pools the cash of thousands of investors and invests that cash in a basket of bonds. The basket may have 20 bonds, or it may have several thousand.

The theory is a mutual fund provides exposure to lots of different bonds, which creates diversification, so that all your money is not invested in just one bond. If that bond defaults — meaning interest is not paid, or principal is not paid, or the company goes bankrupt – the bond can become worthless.

However, mutual funds can absorb any such default, as all the performing bonds will dampen the effect on any single bond loss.

What are the differences between mutual funds and bonds?

By owning individual bonds, you control which bonds you like enough to buy. You pick and choose the bonds you desire, when to buy and sell each of them (if at all), and you are limited by the bonds that happen to be publicly traded.

You, as a bondholder, also have more of a say in how a company distributes its assets in case it goes bankrupt. Stockholders have virtually no say.

With mutual funds, you choose the general bond purchase strategy that you desire, and let the mutual fund managers decide how to execute that overall strategy, using their expertise to make bond purchases.

While the managers pick the bonds they believe are right for the fund, you have no say in the matter. You are relying on their expertise.

So, while you theoretically own bonds from many different companies, you in fact own a chunk of a fund, which in turn owns those bonds.

Advantages of bonds

When it comes to investing in mutual funds vs. bonds, here are the advantages of bonds:

- You choose the desired bond's safety
- You choose the desired bond's yield
- Trading flexibility

You choose bond safety

The biggest advantage in purchasing individual bonds is being able to comprehensively research the company that the bond has been issued by.

Because companies must provide details about all of their financials each quarter, you can determine the company's relative health.

But there's more to that approach.

You may be an expert in something, and if your expertise aligns with the business that a given company engages in, you may have a much better read on the safety and solvency of that company that a fund manager may not.

Whereas managers may avoid some bonds because they perceive them as being weaker than other choices, you may find the market has mispriced these bonds, and find value and a strong yield.

You choose bond yield

With a mutual fund, the managers buy up bonds and the fund will yield whatever that collection of bonds happens to pay out.

If you choose individual bonds to invest in, you can target both your desired yield and desired risk.

Again, using your own expertise or even just through diligent research, you may find bonds that are less risky that offer higher yields than a manager can.

Trading flexibility

A bond mutual fund manager will buy and sell bonds that align towards the fund's specified strategy. You have no say in how they execute that strategy.

If you buy bonds on your own, however, you have the flexibility to buy and sell them as you please.

In a bond mutual fund, the manager may have purchased discounted bonds and hold or sell them if they reach par. You may feel he has made the wrong choice.
If you own those individual bonds, you can decide for yourself whether to hold the bond or sell it.

Advantages of Mutual funds
When it comes to investing in mutual funds vs. bonds, mutual funds have several advantages:

- Diversification
- Reduced risk over time
- They handle the research

Diversification
The prevailing theory on bond funds is that the major advantage of mutual funds vs bonds is that the former provides significant diversification, because a basket of bonds is far less likely to see its individual components crash en masse.

Diversification means you are more likely to see the bond fund perform very closely to the designed strategy of the fund. Some will move up, some will move down, but none will move very much in price. Along the way, they will mostly pay yields as expected.

The diversification thus gives you stability along with that desired yield.

Reduced risk over time
Volatility is a measurement of risk. The volatility of that bond fund is going to be much less than the volatility of a single bond that you buy. Thus, with that diversification comes reduced overall risk.

This is where the statistics term “standard deviation” comes into play. So if you ever wondered why you had to sit through that class, here’s how standard deviation applies.

In this case, the standard deviation of a bond fund measures the amount (and probability) that the fund will deviate from its long term average annual return.

Bond funds tend to have lower standard deviations that stocks. You can find standard deviation data at sites like www.morningstar.com

They handle the research
Rather than take all the time and effort to really assess a company and how its debt is structured and if it can pay those debts, you just rely on the expertise of the bond mutual fund manager.

They probably have more resources and insight than you do on most companies and debts those companies have, and they are more likely to have expertise in a wide variety of companies.

Your time is valuable. That’s why you pay a management fee, so that they earn money while saving you time and effort.

When to Buy Bonds and When to Buy Bond Mutual Funds
As always, most investors should avoid market timing. With that said, an investor can take calculated risks on their fixed income portfolio holdings by watching interest rates. This is because bond prices typically move in the opposite direction as rates. For nearly 40 years, through 2020, interest rates were generally declining, which made for a positive environment for bond mutual funds. This is because the mutual fund investor was able to participate in price increases, as bond yields declined to historic lows.3

- When interest rates are expected to rise: an investor may consider adding individual bonds to their portfolio. This will keep the principal stable while they enjoy the interest received. Investors may also consider a bond laddering approach, which will consist of buying bonds with various maturities as interest rates rise.

- When interest rates are expected to decline: bond prices are rising; therefore bond mutual funds and bond ETFs can be a wise choice. Some fixed-income investors also like to combine bond mutual funds with individual bonds within their total portfolio. This acts like a hedge or a diversification strategy to protect against multiple economic outcomes.

Bottom Line
A common misconception about bonds and bond funds is that they are "safe" investments. The primary risk with bonds is the potential for the issuing entity's default. Investors can get some help from credit rating agencies, such as Standard & Poor's, by reviewing their ratings (AAA is highest rating, D is the lowest rating) but credit ratings are not guarantees about the issuing entity's financial soundness.

Bond investors should be careful to diversify into different industries and use caution when buying bonds with low credit ratings (junk bonds). Bond funds can also lose principal and can carry more market risk than individual bonds, especially in economic environments where interest rates are rising (and prices are therefore falling).

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