Bond Funds 101

There's a lot to like about income-oriented investments

Bond funds don't always get the attention that stocks get among investors. But fixed income investments are an important part of the capital markets that deserve to be included in most investors' portfolios. In fact, bond mutual funds have become an accepted way for U.S. households to invest in the bond market. In mid-2015, about 42% of such households owned at least one bond fund, according to the Investment Company

Institute.[1]

When you buy stocks, you own. Bonds, you loan. A bond is, very simply, an IOU — a loan by a bond holder to a government body or corporation. The borrower promises to pay back the bond holder the amount of the loan, plus interest, by a specific date (although some bonds can be retired before the maturity date). Generally considered safer than stocks, bonds can provide a steady amount of income in the form of fixed semiannual payments.

In general, bonds can be divided into various maturities (that is, the date when the borrower must pay back the loan plus interest): short term (1-3 years), intermediate term (4-10 years) and long term (10-plus years). The shorter the maturity, the less likely the bond will fluctuate in value. That's because the borrower's payments in the near term are generally considered to be more certain than promises to pay way into the future.

When interest rates rise, the price of a bond goes down. This is because people who are able to buy newer, higher-paying bonds will not find the current lower-yielding issues as attractive. If a bond is sold prior to maturity, the market price may be higher or lower than what the investor originally paid for the bond. This can lead to a capital gain or loss. However, if the bond holder holds the bond until the maturity date, he or she will get 100% of principal back, plus any accumulated interest.

Bond funds may help you diversify and lessen risk. Unlike buying a collection of individual bonds and managing them yourself, owning a bond mutual fund that pools money from other investors offers several advantages:

- Professional management: Mutual funds hire experts who have special education and training in researching borrower companies. These professionals will buy and sell bonds on your behalf, based on the fund's investment objective.
- Built-in diversification: A fund's size allows it to own bonds from lots of issuers (governments, municipalities, highly rated companies, low-rated companies). If you were to buy individual bonds (many in $10,000 denominations), you likely would find it difficult to assemble enough to achieve a diversified portfolio.
- Small investment minimums: Some bond funds cost just $250 to get in, while others have no minimums if you commit to investing a small amount each

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month inside your retirement plan.

- No specific maturity date: In a fund, bonds are constantly bought and sold, so there is no need to worry about what to do with the cash when a bond matures, as you would as an individual buyer. However, bond funds have a weighted average maturity date that is a composite of all bonds held in the portfolio. This means a bond fund could potentially be less sensitive to interest-rate movements than a single bond.

What do I need to know before investing?

Bond funds generally entail less risk than stock funds, but they also tend to offer less reward.[2] In addition, bond funds are sensitive to economic forces, including interest-rate changes. When rates rise, you may want to favor bond funds that have low or intermediate duration, as the prices of the bonds may be less influenced by higher rates than longer-duration bonds would be. Still, because bond returns tend to move independently of stock returns, they may be an important diversifier for your portfolio.

[1] ICI Research Perspective, “Characteristics of Mutual Fund Investors, 2015”. http://www.icifactbook.org/ch6/16_fb_ch6

[2] Investing in bonds and bond funds entails risk, including the risk of losing money. Bond-investing risks include interest rate risk, call risk, duration risk, refunding risk, and default and credit risk. For a helpful discussion of these risks, visit FINRA’s website: http://www.finra.org/investors/understanding-bond-risk.

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