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Don't confuse bond funds with owning actual bonds

Eileen Ambrose -- Personal Finance

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THE RECORD \$140.4 billion that flowed into bond funds last year could be a healthy sign of investors diversifying their portfolios. But some financial experts suspect there's more behind it.

"People are scared to death of the stock market," said Douglas Robinson, a financial adviser with Robinson Financial Advisory in Bel Air.

Burned by stock losses in recent years, investors have fled to bond funds that have been posting gains, experts said. For instance, intermediate-term bonds averaged an annual total return of 8.92 percent for the three years that ended in April, while the S&P 500 index lost an average of 12.96 percent each year, reports Morningstar Inc.

Thomas Muldowney, managing director with Savant Capital Management in Rockford, Ill., said some investors now rushing to bond funds are likely those who bailed out of bonds in the late 1990s to chase high-priced stocks.

"The problem is they do both things at the wrong time," Muldowney said. "They sold bonds when they were low and bought stocks high and sell stocks when they are low and are buying bonds when they are very high."

If current trends continue, money pouring into bond funds this year will set another record. And while bond funds can add diversification and stability to portfolios, some experts are concerned that investors don't understand their risks.

"I call it a flight to perceived safety," said Nathan Gendelman, a client investment strategist with the Family Firm in Bethesda. Some investors wrongly assume bond funds work the same as individual bonds, he said.

With an individual bond, you invest, say, \$10,000 in a top-quality bond paying 4 percent in interest each year. You won't get more than \$400 each year in income even if rates go up, but you won't get less if rates fall. If you hold the bond to maturity, you will get your \$10,000 back at the end of 10 years.

There are risks. Sell the bond before maturity, and - depending on interest rates - you may have to accept less than your principal to attract a buyer. Or financial troubles might cause a corporation to default.

Bond funds, on the other hand, don't guarantee principal.

A bond fund may own hundreds of individual bonds, with the fund manager buying and selling them daily to take

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profits or improve the portfolio's structure. The fund also generates income as interest earned on the bonds in the portfolio is passed on to investors.

But a bond fund has no maturity date, and the share price - or net asset value - changes daily. Like any other fund, it's possible that the net asset value could fall below what you paid; if you sell at that point, the paper loss becomes real.

Some experts, too, say that investors may not realize that bonds, like stocks, run in cycles.

"Most people have a sense that the stock market is somewhat cyclical in nature. You do well for awhile, you lose for awhile," said Eric Jacobson, senior analyst with Morningstar.

With bonds, Jacobson said, "Prices are driven by interest rates, and interest rates tend to be very cyclical."

One of the best examples of that is 1994. During the early 1990s, the Federal Reserve repeatedly cut interest rates to stimulate the economy. Falling rates mean higher bond prices because older bonds paying, say, 8 percent, will command a higher price from investors than a new bond offering 6 percent.

In 1994, the Fed did an about-face, raising rates six times to slow the pace of the economy. Bond prices dropped, because older bonds offering a lower interest rate were less attractive than new bonds.

Bond fund assets that year fell about \$92 billion to \$527.2 billion as values dropped and investors bailed, according to the Investment Company Institute.

Like a decade ago, the Fed has aggressively cut interest rates, though experts warn against drawing parallels. Investors should resist trying to time when best to jump into stocks and bonds and develop a portfolio based upon their goals, how much time they have to invest and how much risk they can handle, experts said.

Stocks traditionally provide the best returns over many years, and are the choice for investing for long-term goals, such as retirement. But bonds add stability to a portfolio, and that can keep people from throwing in the towel when stocks take a dive, experts said.

Bond funds come in different risk levels. You can choose from the high quality funds, which invest in U.S. Treasury bonds and top-rated corporate issues, to so-called junk-bond funds, which invest in bonds of companies with below-investment-grade credit ratings. It's unlikely those investing in a high-quality bond fund for at least five years will lose their original investment, Jacobson said.

Make sure you check the fund's annual fees, which can range from about 0.2 percent to more than 1 percent. That may not sound like much, but over many years fees can substantially erode returns.

"It's like having a slow leak in your tire or a leak in your plumbing. You can ignore it for awhile; it won't seem to hurt you. But you may find yourself sitting on the highway or find your basement flooded," Muldowney said. Paying high fees can leave you without enough money in retirement, he said.

To suggest a topic, contact Eileen Ambrose at 410-332-6984 or by e-mail at [eileen.ambrose-@baltsun.com](mailto:eileen.ambrose@baltsun.com).

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