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The Last Word

There are two ways that companies and governments borrow. One is to use banks and the other is to use bonds, which is a way to borrow from whoever buys the bonds.

Do investors get a good deal? Yes. Over time, bonds pay less than stocks and property. But the return is predictable, plus bonds are the best way to reduce volatility when you add them to any portfolio.

We talked about debt last week, but we skipped over a key question: Which is best, an individual bond or a bond fund? The difference is huge, especially since interest rates are (probably) about to rise.

That is the question. What is the answer?

As you may have guessed: "It depends." On what? Mostly on your preferences, and to a lesser extent, on how much you invest. As for where to buy, you have the usual choice of a bank or a stock broker.

INDIVIDUAL BONDS

The advantage of buying an individual bond is it is one of the few investments where it is nearly impossible to lose money. That is because bonds are almost certain to pay all interest due, plus principal. Where else can you be so sure of getting a steady return and not lose your principal?

True, you could lose money if the firm went broke but it is easy to handle. Simply invest in investment-grade bonds and avoid the risky ones, called junk bonds. But these have benefits of their own since the risk makes them almost like stocks, with high risks and returns.

A second danger is if the ratings are wrong. It is rare but can happen, like when a new type of bond received too high a rating from Moody's, S&P and Fitch. This was highly misleading and in 2008, it contributed to the US housing market failure as well as the worldwide recession.

Fundamental to bonds is the inverse relation between a bond's prices and market interest rates. It only happens with bonds and the rule is: When market rates rise, bond prices fall and vice versa.

Now, imagine market rates rise, as expected, over the next two or three years and, as just explained, bond prices fall. Does it mean you will suffer a loss?

Yes, it certainly does. But the good news is it is temporary, which makes it loss-free if you simply hold the bond and wait until it matures, like in one, two, five, 10 or 20 years.

If you don't sell, the loss is a paper one, also called an opportunity loss. It becomes real only if the bond price falls and you sell. Hold on, and you can be confident of getting your money back since the company must repay its debts or bondholders can force it into bankruptcy.

QUICK QUOTE

> **"I've been accused of vulgarity. I say that's bull****."**
>
> MEL BROOKS, 89
> COMEDIAN

It is almost certain to pay in full if it is an investment grade bond, which is ranked BBB or higher by Standard and Poor's. But what about unranked bonds? Ah, that is another problem for another day.

The rule I just explained about repayment of principal supersedes all others, including the rule that high interest rates bring down bond prices. Think of those lower prices as a temporary effect. By maturity, the bonds will have risen to repay the full amount borrowed, called the face value or par value.

What a deal! There is no other investment where you will get back your money plus interest with almost no chance of loss.

THE ALTERNATIVE: FUNDS

Now for an equally popular choice: Bond funds. What makes them opposite from individual bonds is they are continuous. When one bond matures, the fund takes the money it receives and buys another.

Photo: Thinkstock

But if interest rates have risen, the new bond will be priced lower and that lowers the fund's price. It is similar to the stock market opening "gap down" from the previous day's close. Of course, it can work the other way too. If market rates fall, bond prices will rise and fund owners will enjoy a capital gain, which they can sell at a profit.

More important than the fall in price is the higher yield the fund will earn when interest rates rise. This turns out to be dominant, so the net effect from falling prices and rising yields is positive, as is expected to happen soon.

An important advantage of funds is they hold multiple bonds, which provides diversification. That is especially useful for high-yield and risky bonds, like junk bonds, where a few may fail but you don't know which.

It is also beneficial as a way to get bonds that you probably can't buy on your own like certain junk bonds, emerging market bonds and convertible bonds. You usually find these in an ETF rather than a bond fund.

As for costs, it is a drawback for bond funds and even for the famously cheap ETFs. That is because both charge annual expense ratios while individual bonds do not.

So which is best? Well, it is like asking: "Which is better, vanilla or chocolate ice cream?" Of course, that is a matter of individual preference, just like the choice between an individual bond versus a bond fund versus a bond ETF.

A rule of thumb is to buy a fund or ETF if you invest less than $100,000 and buy individual bonds if you invest more than $100,000. But it is a rough guide and most people simply follow their preference.

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An adjunct professor at SMU, Dr Haverkamp contributes this column weekly to help our readers understand money matters better.

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