COMPASS WATCH

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The Compass Bond Ladder or Bond Mutual Fund When Interest Rates Are Rising?

As bond investors already know, when interest rates rise, the price of existing bonds generally falls. The benchmark 10-year U.S. Treasury bond yield has climbed from its July 2016 low of 1.36% to 3.11% as of May 2018, its highest since 2014. Three percent in some ways is just a psychological level, but it does prompt investors to start to ask about their exposure to interest-rate risk.

In the Winter 2017 edition of *Compass Watch*, "Remembering the Role of Bonds, Even in a Rising Rate Environment," we pointed out that risk mitigation and predictable cash flows were important considerations when choosing bonds, and we continue to advocate the importance of bonds in a portfolio, even if rates are rising.

Investors, however, are faced with a fundamental question: How do you decide whether to own individual bonds (implementing a laddered approach) or a bond mutual fund?

It's doubtful many bond mutual fund investors truly understand what they are buying, but there are a few good features available with a properly selected bond mutual fund. For example, they may be the only way investors can invest small amounts into bonds with some level of diversification and liquidity.

Less understood are the *drawbacks* of many bond mutual funds. Some have hefty up-front sales charges, ongoing management fees, and redemption charges. Others operate according to guidelines which do not match the investors' expectations, goals, or needs. Many bond mutual funds also use market timing techniques that may hamper returns and greatly increase the risk characteristics of the fund. A large number of investors were caught unaware of the risks they were undertaking when many bond mutual funds owned during the 2008-09 downturn declined significantly ***more*** than equity mutual funds.

A Few Factors to Consider

	Compass Individual Bond Ladder	Bond Funds
Diversified	Yes	Yes
Maturity	Known & set maturity date	None
Income Payments	Fixed, predictable & paid semi-annually	Unpredictable with fluctuating monthly payments
Ongoing Sales Charges	None	Annual internal fees—may also have front or back-end sales charges
Return of Principal	High degree of certainty	May not return original investment
Tax Consequences	Greater control	Investors experience uncontrollable & periodic capital gain recognition

If control over your bond investment decisions and increased tax flexibility are important to you, utilizing a ladder approach of high-quality individual bonds is appropriate. The simplicity and flexibility of this approach allows investors to customize a portfolio for diversification, quality, and maturity, while generating a predictable income stream.

A major advantage of the Compass bond style is that it is easily understood and avoids the ongoing expenses associated with bond mutual funds. Our clients know what we are doing and why. We have been following a consistent bond discipline successfully since 1988. We construct our bond portfolios by equally-weighting our maturities 1–10 years. We use a ladder approach to mitigate risk and control volatility within the portfolio. The primary goal of a laddered bond portfolio is to achieve a total return, over **various** interest rate cycles, comparable to that of either a longer-term bond or bond fund but with **less** market risk.

If you are interested in learning more about how Compass manages bonds, give us a call. And if you are considering investing in a bond mutual fund, also please call. We won't charge you for the conversation, but we may just save you from a great deal of emotional and financial aggravation.

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