5 Reasons to Invest in Bond Funds vs Bond ETFs

FundX because markets CHANGE

We like exchange-traded funds (ETFs), but when it comes to bonds, we believe funds are a better bet. Here's why

1 Bond funds add value through active management

Some say that few active managers beat their benchmark index over time, but there are many fixed income managers who have beaten their benchmark consistently for many years. Just as important, active fixed income managers make risk management a priority by employing teams of credit analysts. This expert credit research helps reduce default rates and improve recovery results. Actively managed funds can also consider investing in less widely traded bonds that index-based ETFs may not have access to.

2 Bond funds have proven track records

The first equity ETF began 20 years ago, but bond ETFs are relatively new; the oldest bond ETF is only around six years old, and most bond ETFs are less than three years old. Bond mutual funds, on the other hand, have been around for decades. We take comfort in knowing the actual performance of various strategies through good and bad markets. We have also seen that bond funds that are designed to track major indexes have rarely been top performers.

3 Bond funds are less volatile

Bond ETFs are generally more volatile than bond funds (see an example under #5 below), and one of our goals in managing fixed income is to limit volatility. One reason ETFs may be more volatile is that they can be sold short, which means that bond ETFs can be sold, even by people who don't own shares of the actual ETFs. Essentially, hedge fund managers and other active traders can buy individual bonds that they like and then hedge their overall bond market exposure by short selling an index-based ETF. This can lead to increased volatility in ETFs – especially for those that trade high-yield bonds.

4 Bond funds trade at NAV

ETFs have arrangements with market makers to provide liquidity, but market markets they aren't obligated to bring an ETF's price in line with the ETF's net asset value (NAV). There is no guarantee that ETFs will trade at the value of their underlying net assets (NAV). Because bonds are more expensive to trade than stocks, most bond ETFs typically trade slightly above NAV to compensate ETF market makers for these added trading costs. In a down market, these same bond ETFs may trade below NAV, sometimes substantially, when there are more sellers than buyers and market makers are unwilling to bring the ETFs back to NAV.

This happened in 2013 as rising interest rates in May and June prompted investors to unload their positions. Barron's reported on June 15, 2013 that "more than half the market-price declines of all bond ETFs outpaced the drop in their underlying assets last month, according to Morningstar. It was especially pronounced in junk bonds, where iShares iBoxx $ High Yield Corporate Bond's (HYG) market price dropped 2.6% for the month, much worse than the underlying assets' 1% decline."

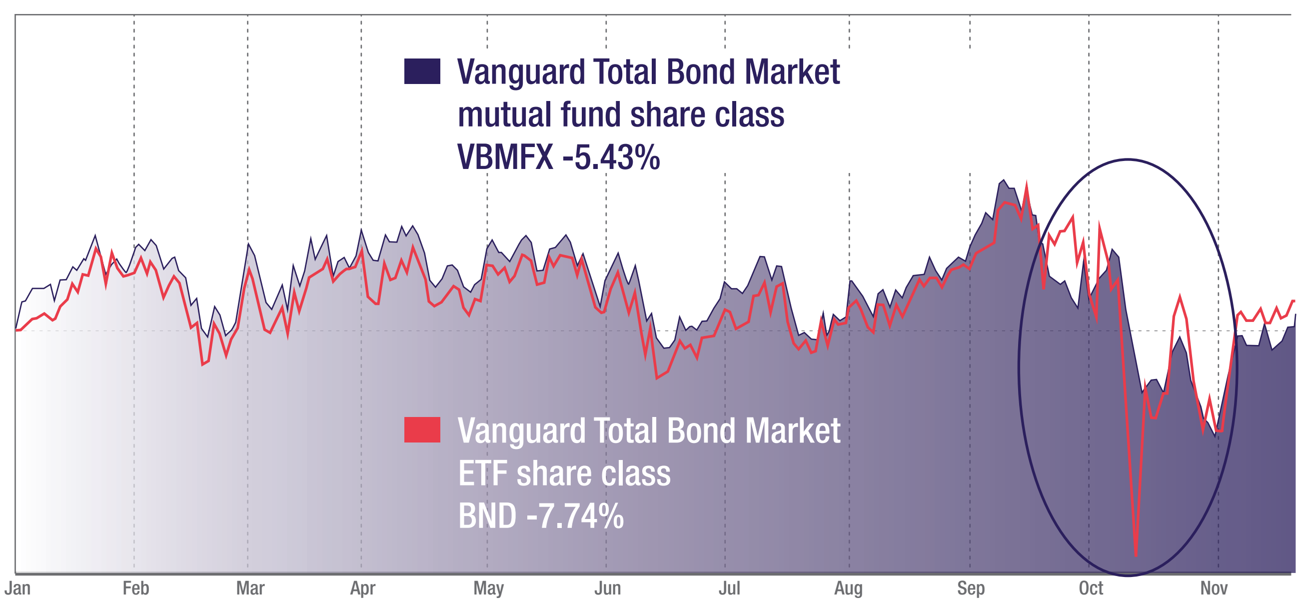
Bond funds didn't have any of these problems in 2013. Bond funds always trade at NAV, so you don't ever pay a premium at the time of your purchase and you also don't risk selling below NAV if you sell into a down market.

5 Bond funds have offered better risk-adjusted performance

Consider the Vanguard Total Bond Market Fund, which has both a mutual fund share class (VBMFX) and an ETF share class (BND). Since both tickers represent the same fund portfolio, they should have identical performance, and over time, they do. But BND is more volatile, partly for the reasons described above. The maximum drawdown, the biggest loss peak to trough, for both the mutual fund and the ETF occurred from early September through late October 2008, but BND lost noticeably more than VBMFX during this short time period (see chart below).

Vanguard has other share classes of the same bond index portfolio, including the Admiral shares (VBTLX). When you compare the performance and drawdowns of VBTLX and VBMFX, you see that the funds do move in tandem (the only difference in performance comes from the difference in the funds' expense ratios, 0.10% vs. 0.20% annually), and the maximum drawdown of the Admiral shares in 2008 is -5.42% — very close to that of VMBFX.

We don't think investors should accept greater volatility if they aren't get compensated by better performance. High yield bond funds like Janus High-Yield (JAHYX) or Fidelity High Income (SPHIX) have consistently performed better than high yield ETFs like SPDR Barclays Capital High Yield (JNK) and iShares iBoxx High Yield (HYG) and with less volatility.



maximum drawdown period 9/08-11/08

When to Consider Bond ETFs

Although we generally prefer bond funds, we do use some bond ETFs at times. For example, if we add to junk bonds in times of stress, we may buy SPDR Barclays Capital High Yield (JNK) when it is trading at a discount. We also use bond ETFs in categories that are typically less volatile and where lower expenses add the most value, like very short-term Treasuries.