An idiot's guide to bond funds

by **Warren Bird** on September 12, 2014 0

A question from Cuffelinks reader, James

I appreciate your readership includes many professional investors as well as advisers who would be all over this, but I think there are a lot of average Australians, including many who look after their own SMSF, who don't fully understand the machinations of bond funds – there appear to be more moving parts than a simple, old equities fund. May I suggest a series of articles that might consider the following topics:

- an idiot's guide on how to analyse a bond fund. What is the significance of duration vs credit risk? Should one invest in them for income or capital gain? Are there some bond funds that should be included in the growth section of a portfolio as opposed to the defensive? Is a 70/30 split crazy when interest rates are at all time lows?

- a discussion of the merits of passive vs active investing in bonds (it is my understanding that most bond funds have underperformed passive funds over the past ten years, much like active equities funds)

- an explanation of these new-fangled 'unconstrained bond funds'. Are they just a fad? Are they a genuine solution to the duration risk argument? Have they been created in response to bond fund managers wondering where the next dollar will come from after a 30 year bull market?

The term 'idiot's guide' is colloquial, of course, but the workings of bond funds seem more complicated to many than equity funds. Perhaps the real issue is that investors don't understand equity risk as well as they should and have misguided beliefs about how straightforward their share fund actually is. But that's another story!

There's no doubt that anyone considering investing in a bond fund faces an array of information about the various products on offer that can make their choice seem anything but straightforward. Take the names of the funds they can choose, for example. There are Australian Fixed Income, Income Focused Bonds, Australian Corporate Bonds, Global Credit, Diversified Fixed Income, Global Bonds, High Yield and many more. Even the same manager will have at least a couple of these options on their list.

This article aims to cut through the confusion and provide a guide to understanding the world of bond funds. When an investor looks at the 'fact sheets' of bond funds, what are the important features to take note of? What do they need to know to make a decision that suits their investment needs?

The three main features of any fund to check out are: **yield, duration and credit quality**.

Yield

A fund's yield is a weighted average of the yields of the individual bonds in the portfolio. It will usually be referred to as the 'yield to maturity', or the 'effective yield'. It's analogous to the dividend yield of an equity portfolio. However, whereas dividend yields relate current dividend payments to share prices, bond yields factor in all the future interest payments, through to the bond's maturity. This is possible because the payments are fixed, or based on formulae that can be predicted. A bond fund's yield gives a good estimate of the income return it will pay over time. Usually, it will also give a decent estimate of the total return over a several year period.

Yield estimates aren't perfect predictors of income returns, however, for the following reasons.

First, it's assumed in the yield calculation that all bonds are held to maturity. This may be the case in an indexed bond fund, but is rarely true in an actively-managed fund. Active managers make decisions to sell bonds that they no longer find attractive and buy bonds that they believe will perform more strongly. If they are successful, then they will achieve a combination of realised capital gains and/or higher yields that produce additional income and return, over and above the initial yield estimate. And vice versa if their decisions don't work out.

Another important assumption is that all cash flows will be reinvested at current market rates. This rarely works in practice. If yields rise then reinvested cash flows will earn the new, higher, interest rate. That will enhance the income return compared with the yield, and vice versa if yields fall.

Those caveats aside, if you know that a bond fund has a yield today of X% then you can have a high degree of confidence that it will give you an annualised income return of close to X% per annum over the next few years. Exactly how many years depends on duration.

Duration

The duration of a bond fund gives you an idea of the time period over which the yield will play out. Duration is a measure of the period over which the cash flows of the bonds in the fund will be received; it therefore gives a guide to the time period over which investors should consider the fund's performance. The main difference between investing in an individual bond and a fund is that the individual bond's duration gets shorter over time, falling to zero at maturity. A fund, however, doesn't mature. Instead, maturing bonds are reinvested so that a fund's duration is managed within a stated range.

Short duration funds own either lots of short term to maturity bonds, or they own floating rate notes, and thus haven't locked current yields in for very long. Investors can expect to earn the yield for a year or two, but after that will depend heavily on future market conditions.

Longer duration funds – which are typically those that just have the term 'bond fund' in their name – own a mix of fixed income securities that mature from one to ten or more years. These have locked in current yields for longer.

Duration also gives an idea of the short term volatility you can expect in the unit price. When market yields fall, the value of bonds increases and so will the unit price of a bond fund; vice versa when market yields rise. These movements are more significant for longer duration funds than for short duration funds. This was explained in **an earlier Cuffelinks article** so the mechanics won't be repeated here. However, it's important to realise that these are not permanent gains or losses, and don't affect the income return of the fund. They are literally just short term price volatility.

The capital price risk that is really important to be aware of comes from credit risk.

Credit risk

Bonds are promises by an issuer to meet payment obligations. If all goes well the investor receives those payments, including their money back at maturity. There is no capital upside. If all does not go well for the issuer, then the investor may lose some or all of their capital.

Therefore, the credit quality of a bond fund is important to understand so you can have an idea of the downside risk from capital loss if any of the bonds held in the fund defaults. Bonds with weaker credit quality typically pay investors a higher yield than those with stronger credit quality. Certainly, professional bond fund managers will look for extra yield to take more credit risk in a portfolio.

Credit risk and credit risk management have been discussed in **this previous Cuffelinks article** and **this one** .

Managed funds really come into their own in relation to credit risk, because pooled vehicles can diversify far more effectively than individual investors. There is a broad range of funds in the market that take different degrees of credit risk.

Usually those that are called "Australian Bond Fund" or similar will hold only investment grade rated credits. That makes them very safe, but doesn't make them 100% immune from defaults. For example, many Australian funds held the Australian dollar bonds issued by Lehman Brothers back in 2008 and thus experienced a small loss of capital when Lehman defaulted.

Other funds will go down the spectrum into sub-investment grade, or 'high yield'. Those funds are more likely to experience default losses. They will also earn much higher yields to compensate, but to be well managed these funds need to have smaller limits on individual holdings and appropriate diversification to ensure that total returns remain high even if some bonds don't work out so well. Investing in high yield was discussed in **another recent Cuffelinks article**.

Finally, it's important to realise that if a fund that invests in credit falls in value that doesn't mean it's experienced defaults. Credit funds have duration and if the yields on the bonds in a credit fund go up, then the mark to market value of the fund will fall. This is the same as for a government bond fund and the loss of value is not a realised loss of capital in those circumstances.

Conclusion

When you look at any investment you need to have an idea of its expected return and the risk that it will let you down. With bond funds, the yield tells you the expected return, while duration and credit risk information gives you an idea of the risks that you won't earn that return.

There's more to know about bond funds than this, of course, but if you have these three pieces of information you'll be in a good position to distinguish among different funds and therefore make an informed choice about which one might suit your investment needs.

We will return to the rest of James's question in a subsequent article.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest. His comments are general in nature and readers should seek their own professional advice before making any financial decisions.

Related Posts:

1. **Bond funds and term deposits are apples and apples**
2. **Bond investing as rates rise**
3. **What do bond and equity yield differentials tell us?**
4. **Fixed income investing when rates are rising**

bond funds, **bonds**, **credit risk**, **duration**, **fixed interest**, **yields**