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Off the Ladder:
Funds offer an alternative to a favorite style of individual bond investing

By CHARLES R. FELLERS | 04-08-2002

Two stinging years of negative returns on stocks have brought many investors to the threshold of the world of bonds. But the crucial question of how best to enter this realm brings lots of confusion to investors. The key decision they face is whether to use bond mutual funds or individual bonds to meet their investing goals, a choice made tougher by the current state of the fixed-income markets. Investors these days see a dearth of new issues, discouragingly low yields and face values that promise to drop as soon as soon as the Fed starts pushing up interest rates.

"A year ago, when I could just throw a pen at my screen and hit 7% on my inventory anywhere on the yield curve, all I did was ladder," says Patti O'Malley-Knox, vice president of investments for A.G. Edwards in Abilene, Kan. "In that environment, one size fit almost everybody."

By "ladder," O'Malley-Knox refers to a popular strategy for building a bond portfolio. An investor buys a series of individual bonds that mature at regular intervals. A ladder might include bonds that mature in two, four, six, eight and 10 years. When the first group of bonds (fittingly called rungs) matures in two years, all the other bonds are two years closer to maturity and the investor reinvests the proceeds of the first rung in bonds 10 years from maturity. The ladder then looks the same as at the outset, with maturities at two, four, six, eight and 10 years. The process is continually repeated.

Laddering is one of the simplest bond strategies, and O'Malley-Knox says her clients are happiest when she keeps advice easy to understand: When one bond comes due, buy another. But, lately, she has been looking into other fixed-income vehicles, including bond mutual funds.

Bond funds provide diversification for small investors and can fill a portfolio's fixed-income allocation requirement. But bond funds aren't bonds. Most notably, they don't carry the same principal and coupon guarantees that make bonds popular among retirees and others who live off monthly checks.

Individual bonds mature on a set date for a set amount, but before their maturity date, the price they fetch on the open market fluctuates. The net asset value of a bond fund reflects the fluctuating market value of its holdings.

"I think bond funds are much more suitable for the smaller or less-sophisticated investor," says Charlie Driscoll, a financial-services representative with MML Investor Services in St. Louis. "And you know what? That's about 95% of the investors out there."

By investing in funds, investors don't have to research individual bonds, look into their call provisions or investigate companies' creditworthiness. The fund managers do all that, as well as packaging the bonds' interest payments into steady dividend streams. And bond funds make reinvestment of those dividends easy.

Besides that, institutions such as mutual funds can buy bonds at better prices than individuals in just about every type of bond market.

"When a municipal bond comes out priced at 96, individuals might buy it for 99 7/8 and think they're getting a great deal," says Zane Brown, partner and director of fixed-income investments at Lord Abbett. "We might get that same bond for an eighth or a quarter" point over the dealer's purchase price, which would be 96. (A bond price reflects the percentage of its redemption value; "par" for bonds is 100.) Institutional managers such as Brown are offered such low spreads because of the large amounts they purchase. Critics of bond funds often object to management fees, but fund managers say their spreads more than makes up for them.

Bond funds tout the flexibility active management offers over laddering and other passive strategies. Ladder investors hold their bonds until they mature (or are called -- that is, redeemed ahead of time -- by the issuer) and then quickly reinvest in another series of bonds of longest maturity on the ladder.

"It's like deciding you're going to play golf on the 17th of every month no matter what the weather is like," says Clark Stamper, portfolio manager of the Evergreen High-Income Municipal Bond fund. "And if it rains, you're stuck with bad interest rates."

By always buying the same maturity, ladder investors ignore opportunities that may hide in other maturities. Also, the ladder assumes that the best strategy is buying the next rung on the reinvestment date, and that the best day to sell a bond is the day it matures.

But investors who hold to maturity never take advantage of a premium that may emerge as bonds trade above par in a fluctuating market. As the bond market fluctuates, bonds trade well below or above par.

Not only that, but an owner of individual bonds with call provisions risks seeing those securities heading home to papa if the issuer sees an opportunity to refinance at lower rates, forcing the ladder investor to reinvest at lower yields. Yet avoiding callable bonds shuts out a significant portion of the market. A bond-fund manager has the flexibility to sidestep the dilemma.

Some brokers refuse to sell bond funds because their clients have been burned by them in the past. "Look at '94," Driscoll says. "It was the worst year ever for bonds." The Fed increased short-term rates to 5.5% from 3%, crushing the market prices of outstanding debt across the board. And bond funds got killed.

Funds are poor candidates for the elderly, fixed-budget types who simply want monthly checks and roll the proceeds over when their bonds mature. The big problem: If interest rates turn the wrong way, the market value of the bonds in a fund will suffer.

To help preserve the invested principal in a bond fund, fund proponents recommend that fund-holders plow back a portion of their dividends.

Stamper, for example, recommends that investors take 85%, or less, of their dividends in cash and reinvest the rest.

Some investors have no choice when it comes to funds or individual bonds, depending on the type of bonds they desire. Many people seek the maximum tax benefit by focusing on bonds that are exempt from state and local levies, as well as from the reach of Uncle Sam. But some bond managers may not deal with debt securities issued by smaller states. And the highest-yielding bonds will be too risky for most investors to take on in anything but a fund that lessens the danger by holding some relatively low-risk paper, too.

So, investors should know their priorities -- inviolate principal, diversification or professional management -- when they consider a broker's pitch about the best fixed-income strategy.

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