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Types of Bond Mutual Funds

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Introduction

A bond mutual fund invests in debt instruments issued by governments and/or corporations. Most of these funds are designed to provide interest income for shareholders in the form of dividends that represent the total interest payments made by all bonds in the fund's portfolio.

Unlike the individual bonds within a bond fund, the fund itself never matures or gets called by the issuer. The fund manager keeps the fund going by adding new bonds to the portfolio as old ones mature or are sold. As a result, you cannot be certain exactly how much you'll receive if and when you decide to sell your fund shares; the amount could be higher or lower than your original investment. That's particularly true if a fund is facing a large number of investor redemptions, which can cause a fund to have to sell bonds even though the manager would prefer not to.

Default risk is generally less with a bond fund than with an individual bond because it is spread among a large number of bonds. Though diversification alone cannot guarantee a profit or ensure against a loss, if the issuer of one bond in a particular fund defaults, a fund investor would not lose his or her entire investment, as can happen with individual bonds.

Caution: *Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing. The return and principal value of a mutual fund fluctuates with changes in market conditions. Shares when sold may be worth more or less than their original cost. A bond fund is subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.*

Changes in interest rates also can affect the value of a bond fund, even one that includes only bonds with stellar credit ratings. When interest rates and bond yields rise, the value of a bond fund is likely to drop, because bond prices move in the opposite direction from yields. However, a fund manager may be able to offset the impact by altering a fund's duration (a gauge of the average length of time interest payments will be made on the bonds it contains). For example, if interest rates are rising, a fund manager might decrease the fund's duration because higher rates would typically have less impact on the value of shorter-term bonds than on those with longer maturities.

A bond fund typically is either an open-end fund or a closed-end fund. Open-end funds constantly offer new shares to accommodate new money as it flows into the fund, and stand ready to redeem shares when the investors want to sell. Closed-end funds issue a limited number of shares when the fund is established, and those shares trade on stock exchanges. A share may be priced either higher or lower than the fund's net asset value, depending on investor demand for the fund.

There are many varieties of bond funds from which you can choose. Each offers its own level of risk and potential return. While some bond funds invest in multiple bond types simultaneously, many focus their investments on a particular type (for example, high-yield bond funds or municipal bond funds). Many investors prefer to do their bond investing through a fund because individual bonds can be challenging and time-consuming to research. You should consult your financial planning professional to determine which types of bond funds are suited to your particular circumstances and investment goals. Before investing, carefully consider a fund's investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing, as you would with any mutual fund.

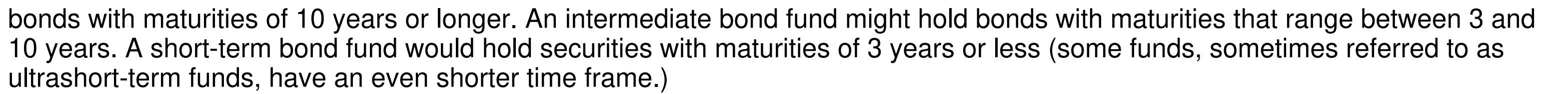
Caution: *Dividends paid on bond mutual funds are technically interest, subject to tax at ordinary income tax rates. These dividends do not qualify for capital gains tax treatment under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Tax planning can be helpful in determining how a bond fund investment can affect your taxes.*

What are some common types of bond funds?

Short-term, intermediate, and long-term bond funds

A bond fund may be categorized by its duration, which is linked to the average maturities of the bonds it holds. While some funds hold bonds with widely varying maturities, others invest in bonds that have similar time frames (though that doesn't mean they all come due at once) and may come from a wide variety of issuers.

Though precise guidelines for what constitutes "short term" or "intermediate" can vary, a long-term bond fund would typically hold



bonds with maturities of 10 years or longer. An intermediate bond fund might hold bonds with maturities that range between 3 and 10 years. A short-term bond fund would hold securities with maturities of 3 years or less (some funds, sometimes referred to as ultrashort-term funds, have an even shorter time frame.)

In general, the shorter a bond fund's duration, the lower its yield, because bond investors generally require a higher interest rate to lock up their money in longer-term debt instruments. And the longer a bond fund's duration, the greater the impact of changing interest rates. Bond prices move in the opposite direction of interest rates; when interest rates rise, bond prices fall, and vice versa. The longer a fund's duration, the more dramatic that motion can be. An intermediate bond fund falls somewhere between the relative stability of a shorter-term bond fund and the higher yields of a longer-term fund.

Bond index funds

A bond index fund attempts to match the performance of a standardized bond index by investing in a portfolio of bonds similar to that of the index. An index reflects changing market values and interest rates for bonds. It might be broad-based, such as the Barclays Capital Aggregate Bond Index, or it might focus on a narrower segment of the bond market, such as intermediate bonds or investment-grade corporate bonds. By contrast, an actively managed bond fund attempts to outperform a given bond index through its manager's selection of individual securities and the timing of bond purchases and sales.

As with any index fund , a bond index fund can be relatively cost-efficient because it typically trades less often than an actively managed fund (usually when the index itself changes). Also, an index fund does not require extensive research on individual bonds. Lower expenses can be especially important with a bond fund because bonds as an asset class normally offer lower returns than stocks. (However, remember that even though a bond fund may come close to replicating an index, administrative expenses may mean it doesn't match the index's performance exactly.)

Government bond mutual funds

A government bond fund is made up of securities issued by the U.S. government and its agencies, such as the Government National Mortgage Association (GNMA). The U.S. government has never defaulted on a bond or redeemed one prior to maturity. That makes a government bond fund a relatively low-risk choice for conservative investors who seek an ongoing stream of current income, such as retirees. However, it's important to remember that while the government guarantees the securities that underlie a government bond fund, it does not guarantee shares of the fund itself.

Government bond funds also offer a tax advantage, because their dividends are generally tax-exempt at the state and local (but not federal) levels. However, because the default risk of a government bond fund is so low, returns usually will be correspondingly low.

A specific type of government bond fund is one that specializes in Treasury Inflation-Protected Securities (TIPS) , which adjust the principal and interest paid on an individual bond every six months to reflect changes in the Consumer Price Index. A TIPS-only government bond fund can be useful if rising inflation is anticipated; however, if inflation is less over time than expected, a TIPS fund could have lower returns than an ordinary government bond fund. A TIPS fund generally invests in a variety of maturities, and pays out not only the interest but any annual inflation adjustments to the bonds it holds. Like other government bond fund dividends, those payments are tax-exempt at the state and local level. And unlike an individual TIPS, which has a government guarantee that the repaid principal will never be less than your original investment if you hold it to maturity, you could receive less than your original investment when you sell your shares in a TIPS fund, which has no such guarantee.

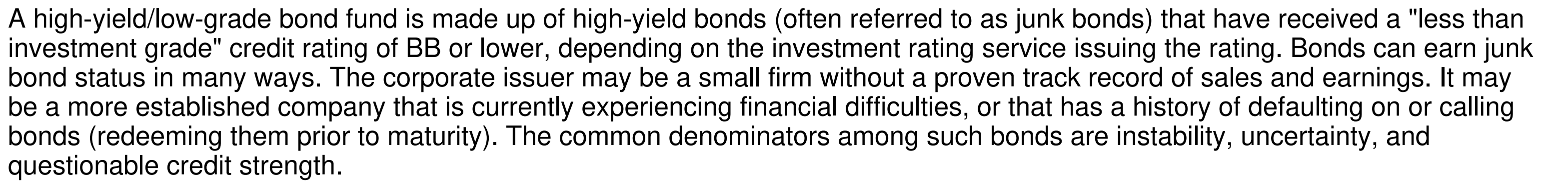
High-grade bond funds

A high-grade bond fund (sometimes known as an investment-grade bond fund) is primarily made up of bonds that have been issued by U.S. corporations and have received a credit rating of AAA or AA from an investment rating service (although the term "high-grade bond" also may include U.S. Treasury bonds and other fixed-income securities).

The high-grade description is based on the perceived quality of the bonds. Though even the most stable corporation could default on its bonds, in most cases, a bond that has been assigned a high grade is believed to have a relatively low chance of default. (However, remember that credit ratings apply only to the underlying bonds, not to the shares of a mutual fund that holds them , and ratings may change over time.) Generally, investment-grade bonds fall somewhere between the safety afforded by U.S. Treasury bonds and higher-risk corporate bonds that offer higher yields.

A high-grade bond fund can be used to provide current income or balance other more volatile components of a portfolio.

High-yield/low-grade (junk) bond funds



A high-yield/low-grade bond fund is made up of high-yield bonds (often referred to as junk bonds) that have received a "less than investment grade" credit rating of BB or lower, depending on the investment rating service issuing the rating. Bonds can earn junk bond status in many ways. The corporate issuer may be a small firm without a proven track record of sales and earnings. It may be a more established company that is currently experiencing financial difficulties, or that has a history of defaulting on or calling bonds (redeeming them prior to maturity). The common denominators among such bonds are instability, uncertainty, and questionable credit strength.

Caution: *Investments in high-yield bond funds offer different rewards and risks from investing in investment-grade securities. These include higher volatility, greater credit risk, and the more speculative nature of the issuer.*

Such bonds generally must pay a higher-than-average yield to compensate investors for their greater default risk. As the name suggests, a high-yield bond fund often will offer a higher-than-average dividend rate, which can be particularly attractive to investors who seek supplementary income and can accept the greater risk these bonds involve. Also, because junk bond yields are more dependent on the quality of the issuer than on other factors, they can sometimes be less affected by interest rate changes than investment-grade bonds are, giving a bond portfolio additional diversification.

However, high-yield bonds are an area in which it can be particularly helpful to have a professional to select bonds with the best risk-return profile--the least amount of risk given the desired level of return. And the diversification of a mutual fund may make particular sense in the case of investments that by definition are relatively high-risk. Finally, some junk bonds may be thinly traded, and an investor may face difficulty executing a trade or finding a buyer for a given bond. Though a fund could face similar challenges, it might have an easier time overcoming them than an individual investor with a single high-yield bond.

Caution: *Although dividends may provide income, they also can raise your income tax liability. If your fund lives up to the name "high yield" and pays particularly large dividends, the tax consequences could be considerable, especially if you are in a high tax bracket. It is important, therefore, to look at a fund's after-tax returns.*

International and global bond funds

An international bond fund invests in bonds issued by governments and/or corporations outside the United States. The portfolio composition may vary in the types of bonds targeted. Some funds focus exclusively on foreign corporate debt, others focus on bonds issued by foreign governments (sovereign debt), and still others strive for a mix of the two. An international bond fund also may focus on debt from developed countries, emerging markets, or a mix of the two.

An international bond fund can help make it easier to investing in overseas markets (in some cases, a fund may be the only way to access markets that are closed to non-citizens). Also, a fund provides international diversification; economic circumstances that affect one country or currency may not have precisely the same impact on another. A fund manager has many thousands of foreign bonds from which to choose, and can shift assets from country to country or from developed countries to emerging markets (or vice versa). Having some overseas bond investments can help balance a portfolio that is heavily invested in the United States, or one whose international investments are primarily equity-oriented. Finally, foreign debt that is perceived as being higher risk also may offer a higher interest rate.

Caution: *Because global credit markets are now more tightly interconnected than ever before, international debt may suffer along with U.S. credit markets in the event of serious financial problems.*

Though terminology may vary among fund families, a global bond fund generally has a broader charter than an international fund. It may invest not only in foreign debt but also in bonds from U.S. issuers. As a result, a global bond fund is typically more broadly diversified than funds that do not include U.S. debt. If the value of the dollar rises while the value of the yen plummets, a global bond fund with both U.S. and Japanese debt instruments will suffer smaller losses than a fund invested largely in the Japanese bond market and holds no U.S. securities (though that also would limit the first fund's gains if the Japanese bond market were to benefit from a weaker dollar).

Both international and global bond funds are subject to the risks involved with any overseas investment. Those include:

- Currency fluctuations: Changes in currency exchange rates can greatly affect returns from any foreign investment. Any foreign security held by an international or global fund will have been bought in the other country's currency, making the security vulnerable to changes in the relative value of that currency. In general, the stronger the U.S. dollar, the worse an international bond fund will perform. In some cases a fund may use sophisticated financial instruments to help hedge its exposure to currency risk (however, such hedges also could hamper a fund's performance if exchange rates reversed course). To the extent that a global fund holds U.S. securities, they may also help moderate the fund's currency risk.
- Political and economic risk: Not all governments are as stable as the United States; political and economic turmoil,

particularly prevalent in emerging markets, can affect bond values and/or lead to defaults, even on sovereign debt.

- Differences in financial reporting.

Such risks are in addition to the risks involved in any bond investment, such as interest rate risk, inflation risk, and credit risk.

Because of the unique operational requirements of researching and investing in foreign bonds, international and global funds may incur higher management and administrative expenses than other funds, which naturally affect returns. Also, because these funds invest in foreign securities, they may have to pay income tax to the countries in which the bonds were issued. A fund passes this tax liability through to its individual shareholders on a pro rata basis. This foreign tax would be in addition to any U.S. taxes an investor might owe. However, a deduction or credit for foreign taxes paid may be available to some investors.

Tax-exempt and state tax-exempt bond funds

A tax-exempt bond fund (sometimes referred to as a muni bond fund) is designed specifically to invest in bonds whose interest income is not subject to federal income taxes (generally municipal bonds).

Note:

Municipal (tax-exempt) bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance. As with any mutual fund, before investing, you should carefully consider the fund's investment objectives, risks, fees, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing. All investing involves risk, including the potential loss of principal, and there can be no guarantee that any investing strategy will be successful.

A state tax-exempt bond fund invests in municipal bonds whose interest income is exempt from federal income tax and also from state income tax for residents of states where the bonds in the portfolio are issued. For example, a New York tax-exempt bond fund would generally consist of municipal bonds issued in that state, which would be tax-exempt for residents of the state of New York.

Multisector bond funds

As the name implies, a multisector bond fund is designed to provide one-stop access to a variety of bond types. Depending on the fund, a multisector fund might invest in corporate bonds (including high-yield junk bonds), international bonds, Treasury securities, and mortgage-backed bonds, as well as other debt instruments. The fund might have a target allocation to each category, but deviate from those targeted percentages depending on what sectors the fund's manager feels are positioned to do well. By holding multiple types of bonds--or in some cases, multiple types of other bond funds--a multisector bond fund has a great deal of flexibility to adjust to changing economic and market conditions.

Because of that flexibility, it's important to understand a specific multisector bond fund's investing parameters. Though it may seem strange given how broad their mandate typically is, multisector bond funds do not necessarily correlate closely with the overall U.S. bond market. Returns are generally highly dependent on the manager's decisions about not only individual securities but about how the fund's assets are allocated to the various sectors it covers. The percentage a fund typically devotes to, say, ultrasafe Treasury bonds compared to junk bonds will affect not only its returns but its volatility. Because a multisector bond fund demands expertise in a variety of debt instruments, a manager's experience and expertise are especially important.

Convertible bond funds

Some bonds, known as convertible bonds , not only pay interest but give the bondholder the right to convert the bond into shares of the company's common stock. Because of that feature, convertible bonds and the funds that invest in them are affected not only by interest rates, as all bonds are, but also by changes in the associated stock prices. A convertible bond fund is likely to benefit if stock prices rise, because the conversion feature on its bond holdings becomes more valuable (though a convertible bond usually is not as volatile as the company's stock price). Conversely, if stock prices fall, a convertible bond fund's value could drop (depending on which companies' convertibles it holds, of course). Convertible bonds combine the income and relative price stability of bonds with the potential for capital appreciation.

A mutual fund streamlines the process of investing in convertible bonds. A fund may have a lower minimum investment than an individual bond. Also, the performance of mutual funds can be less challenging to compare than that of individual convertibles.

To schedule an appointment with Faye Sykes, click here .

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