Should You Hold Bonds or Bond Funds When Interest Rates Rise?

By ROB WILLIAMS | OCTOBER 12, 2017

When interest rates rise, the prices of bonds and shares of the mutual funds that hold them generally fall. With the potential for rates to rise after years at historic lows, income investors are faced with fundamental questions: How do you decide whether to buy individual bonds or shares of bond funds? Is one substantially better than the other? And if so, which is right for you?

In some investors' eyes, bond funds get a bad rap. Individual bonds pay a stated interest rate until they mature, so when you hold them to maturity, you're spared the impact of price fluctuations. On the other hand, bond funds—being baskets of bonds of varying maturities—don't seem to offer the same certainty. Individual bonds may also offer advantages if you're looking to have more of an active role in managing your portfolio and want to avoid unnecessary capital gains, or use strategies, like bond ladders, to manage your portfolio.

Nonetheless, owning bond funds may make more sense to some investors for a couple reasons, even in a rising-rate environment. For example, bond funds tend to offer greater ability to sell at a given price, if you need to on any given day, and more diversification relative to individual bonds. In addition, interest payouts can be automatically reinvested back into the fund—to buy new bonds and compound returns more quickly relative to individual bonds.

Which option is best for you comes down to your personal investment goals, including your time horizon and risk tolerance

Comparing individual bonds to bond funds

First, let's review how individual bonds and bond mutual funds work.

Bonds typically make twice-yearly "coupon" (or interest) payments. If you hold a bond to its maturity date, you receive a principal amount—known as the face, or par, value. In the meantime, the price of the bond can increase or decrease, usually in the opposite direction of interest rates in general: When rates rise, bond prices typically fall, and vice versa.

Holding an individual bond (versus investing in a bond fund) allows you to control whether and when you choose to sell it, and therefore the fees you pay (versus fund management fees). If you do decide to sell the bond before it matures, you'll do so at a price that an investor would be willing to purchase that bond for in the market today, which could be lower than the price you originally paid for it. And if the issuer of the bond defaults, you won't collect all the coupon payments and you may not even recover the face value.

If you plan to hold a bond to maturity, however, its price volatility may not concern you if the bond isn't callable. But that buy-and-hold certainty comes with an opportunity cost: If rates rise while you're holding the bond, you could miss out on the higher coupons offered by newer bonds on the market.

Bond mutual funds, by contrast, include numerous bonds with a variety of maturity dates and income payments. Unlike individual bonds, which pay interest every six months, bond funds' coupon payments are distributed to investors on a monthly basis and can be paid or reinvested to boost returns. Most bond funds also don't have a set maturity date—their bonds are periodically maturing or being bought and sold. Most bond funds will hold bonds of similar maturities (short-, intermediate- or long-term) or types (government, high-yield corporate, inflation-protected, etc.).

While it may seem logical to watch the value of their shares, over time bond fund returns historically have been affected more by interest payments than by changing prices. The timing of regular bond distributions can help you take better advantage of changing interest rates. Because bonds' yields tend to fall as their prices rise, and vice versa, bond fund managers can buy or sell bonds to try to maximize the overall coupon income their funds produce. When interest rates rise, the monthly payments from your bond fund can climb, too—and if rates increase further, so can your monthly income.

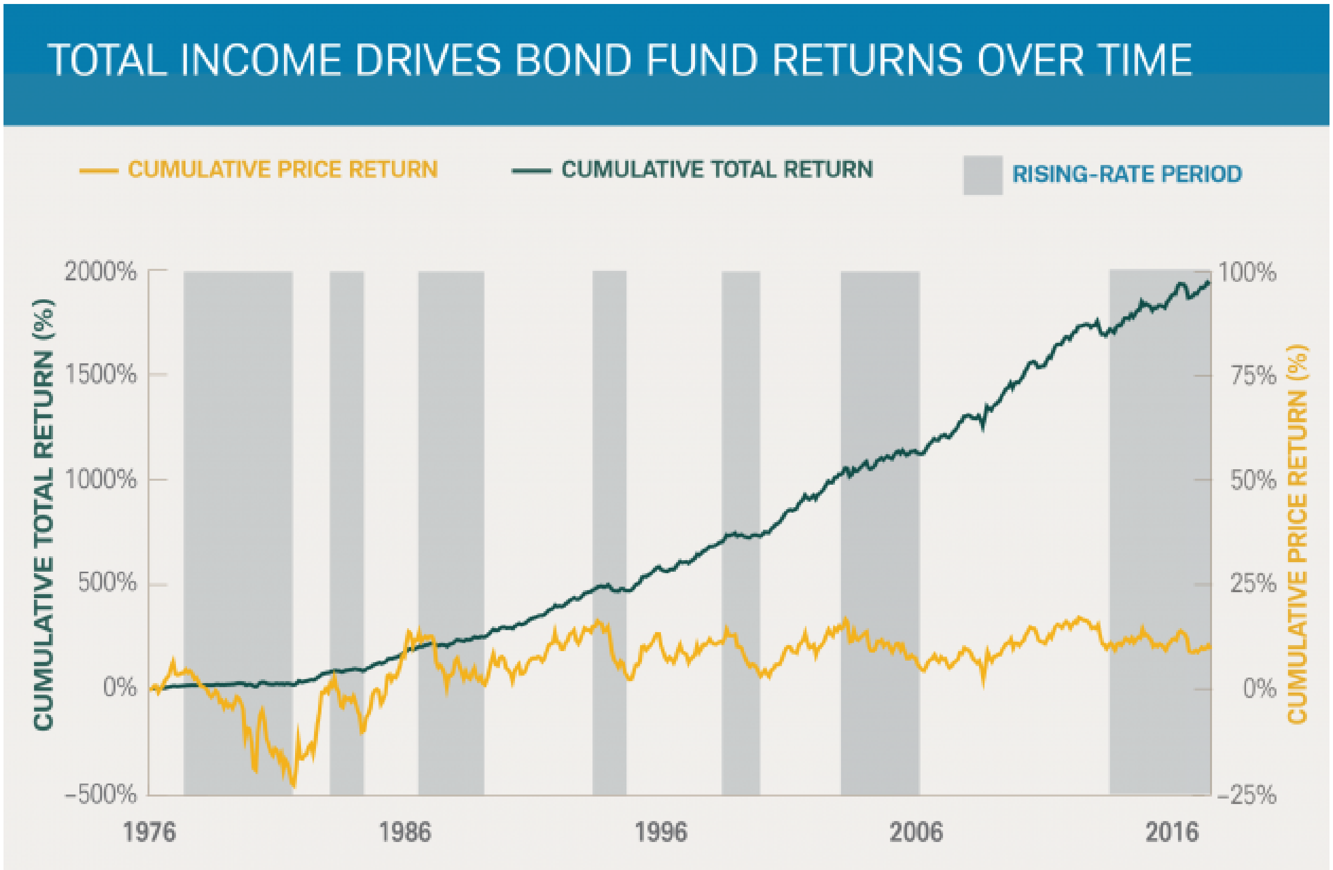
Keep in mind that despite bond funds' income and historically positive total returns, there's no guarantee that you'll recover your principal at a specific time—particularly in a rising-rate environment. With individual bonds, unless the issuer defaults, you'll get your principal back at maturity no matter what rates do in the interim.

The benefits of bond fund income distributions

Since 1976, more than 90% of the total return for a broadly diversified portfolio of U.S. investment-grade bonds (represented by the Bloomberg Barclays U.S. Aggregate Bond Index) has come from income payments rather than a change in price.

There are two good reasons for this: bond sales and coupon reinvestment. When interest rates rise, one way managers can increase a fund's income for investors is to sell lower-rate bonds and buy newer bonds with higher coupons. Alternatively, managers can reinvest the income payments from individual bonds in newer, higher-yielding bonds. That's why many investors choose to have their monthly distributions reinvested to buy new shares.

So while the price of a bond fund may drop in the short term because of rising rates, as an investor your return may increase over a longer period if you choose to automatically invest the income payments. You might see a setback in the price of an individual bond fund share, but distributions can add up and compound to boost returns, which—as seen above—has offset the impact from a change in price of a fund share over time.



Source: Schwab Center for Financial Research with data from Barclays. Returns shown are from monthly Bloomberg Barclays U.S. Aggregate Bond Index returns from January 30, 1976, through September 29, 2017. Total return equals income plus change in price with a reinvestment of interest payments. Rising-rate periods are defined as those in which two-year Treasury bond yields increased by 40% or more over the course of at least 16 months. **Past performance is no guarantee of future results.**

How long might it take to break even?

The amount of time it will take for a bond fund to reach the "breakeven" point—when it fully recovers from any drop in price—depends on a number of factors, including the terms of the bonds in the fund and the speed with which interest rates rise. A fund's category—short, intermediate or long—or its duration, which measures the average maturity date of bonds held in the fund—are good starting points to determine a hypothetical breakeven. All else being equal, short-term funds tend to have shorter durations, meaning they are less sensitive to changing interest rates. Intermediate- and long-term funds have longer durations and, generally, take longer to benefit from rising rates.

The bottom line: Assuming you reinvest bond fund distributions and can hold the investment for several years, your income payments can play a larger role than the price of a bond fund in determining your returns over the long term.

Which bond fund is right for you?

When choosing a bond fund, the first thing to consider is how long you plan to hold the investment. If your time horizon is one to four years, short-term bond funds could be the better option for you because they're lower on the risk/return scale; they generally provide less income, but with less volatility in price. For a four- to 10-year horizon, consider intermediate-term funds, where you'll generally see more income but take on more risk. If you won't need the money for 10 years or more, long-term bond funds, which often sacrifice short-term safety in favor of greater income, may make sense for you.

These days, with historically low interest rates on the rise, intermediate-term bond funds may capture many of the benefits of long-term funds while taking on less interest rate risk. Recent Federal Reserve guidance suggests U.S. interest rates, which edged up slightly in December 2015 (for the first time since 2006) and again in December 2016, are likely to rise further. In our view, this makes long-term bond funds less attractive than short- and intermediate-term bonds or funds.

Another good way to help determine whether a given bond fund is right for your portfolio is by matching its duration to your risk tolerance—that is, how much volatility you can withstand and still sleep at night.

Funds with shorter durations have lower yields, but they tend to recover more quickly from interest-rate hikes. The longer the duration, the more volatile the bond fund's price will be when interest rates rise or fall.

What you can do next

Knowing your risk tolerance and investment time horizon makes selecting bonds or bond funds much easier. The Schwab Mutual Fund OneSource Select List® can streamline the process even further, enabling you to screen a high-quality group of funds based on these criteria. Keep in mind that bond funds typically include management fees, which would lower your returns.

There's no one right answer— bonds or bond funds— for every investor. But with a basic understanding of bond mutual fund dynamics and an honest look at your investment style and goals, there are good reasons to consider bond funds as a key component of your portfolio—even when interest rates are rising.

- Learn more about bonds, bond funds and other Schwab fixed income products.
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