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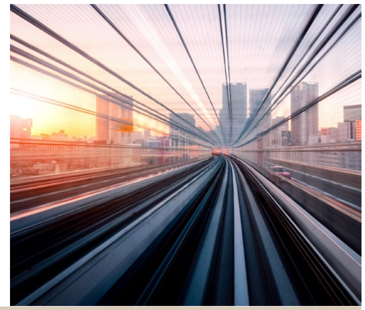
Special Report



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Individual bonds or bond funds, what should I own?

For many investors, owning bonds is an important component of their investment portfolio. However, deciding which bonds to pick can sometimes present challenges as there are many options to choose from. Bonds are issued by governments or businesses with different credit ratings, maturity dates, coupon payments, or legally imposed limits for the issuer. Purchasing the actual bonds can also have its own nuances, depending on if investors use a brokerage account or if they purchase directly from the issuer (for example, direct from the U.S. Treasury). To avoid some of the differences among individual bonds, investors may choose to invest in pooled investment vehicles such as mutual funds or exchange-traded funds (ETFs). There are pros and cons to each approach, and we believe that the answer as to which is preferable ultimately depends on an individual's needs.

What are the differences?

A bond mutual fund or ETF (also referred to as a pooled vehicle) is a portfolio that can consist of potentially hundreds or thousands of different bonds with various maturities, yields, credit ratings, and other characteristics. A key difference between a pooled vehicle and individual bonds in an account is the former's nature as a diversified basket of bonds. While this option may be highly diversified and can potentially lower the credit risk (risk of non-payment) from any individual bond, a fund may not fit a requirement for a specific maturity, yield, or credit rating.

Having a variety of maturities and coupons means that a bond fund has more variability in terms of yield and does not have a definite maturity date for return of principal. An individual bond held to maturity will pay back its principal regardless of the value of the bond between its purchase and maturity date, as long as the issuer does not default and fail to pay. Investors can also more easily implement strategies focusing on specific maturity dates by holding individual bonds, but it may be more difficult with most bond funds as these tend to be more diversified in their approaches to managing maturity schedules. Liquidity management, as a result, may be impacted.

There are also trading-related differences between the two approaches that should be taken into consideration. While U.S. Treasury bonds are comparatively liquid and easy to transact in, municipals, high-yield, or securitized bonds are less liquid and may be difficult for an individual investor to access. By investing in a pooled vehicle, investors may get access to types of bonds that are more difficult for an individual investor to obtain, with the added benefit of being able to sell shares daily. Institutional managers who manage bond funds may also get more favorable pricing than an individual when trading bonds, given their increased size and scale. Additionally, interest generated in bond funds can be reinvested quickly in more shares of the fund, while individual bond interest may not be reinvested until they meet the minimum for a new bond purchase.

Table 1. Main differences between individual bonds and bond funds

Metrics	Individual bonds	Pooled vehicles
Ownership	Full ownership of individual bonds, each with its own maturity and yield	Partial ownership of hundreds of different bonds, each with different maturity and yield
Maturity date	Defined maturity date and value (assuming the issuer does not default) regardless of market movement	Generally, no defined maturity for repayment of principal; value goes up and down with the market
Portfolio characteristics	Easier to implement strategies focusing on maturities; interest stays the same over the life of the bond	Maturity mix can vary greatly; coupon can change over ownership period
Liquidity	Harder to buy and sell specialized bonds; potentially no daily liquidity	Better liquidity and access to specialized bonds; manager may have specialized skills
Management	Active management at individual's discretion	Active management at fund manager's discretion
Taxes	More control over realization of taxes; each bond has individual tax lots	Less control over realization of taxes in mutual funds; tax lots at the level of the fund
Fees	Charged by the investment professional for management and for trading	Charged by the managing firm and potentially by the investment professional

Source: Wells Fargo Investment Institute, as of May 16, 2024.

Differing management styles

The management of a portfolio comprised of individual bonds very often differs from the management of a bond mutual fund or ETF. With a portfolio made up of individual bonds, no changes will typically occur without the investor's direction. A bond fund, however, may change at the discretion of the fund manager or, in the case of an index-tracking bond ETF, if any changes occur at the index level. With an individual bond portfolio, the individual manages the portfolio at the account level. Meanwhile, a bond fund is managed by an institutional portfolio manager. The manager of a bond fund may have access to a professional research team for more in-depth research, which may be beneficial in specialized sub-asset classes. However, the fund will also be managed more in line with the overall goals of the fund and not the individual investor.

Because the management of bond mutual funds and ETFs tends to impact their holdings over time, they are unable to lock in a specific interest rate. Individual bonds will generally pay the same semi-annual fixed interest up until maturity, but a bond fund will generally issue monthly payments (dividends) that may change depending upon the decisions made at the portfolio-manager level. Bond funds that receive inflows during environments of falling interest rates could see their yields decrease as cash inflows would have to be invested in bonds offering lower rates, but an individual bond's interest rate would stay the same. Investors who need consistent payments coupled with a known maturity date may prefer individual bonds.

Differing management styles also impact tax consequences[1], which are different for individual bonds, bond ETFs, and bond mutual funds. Bond mutual funds may be impacted by decisions from the manager or redemptions from other investors and may generate unanticipated capital gains or losses. In the case of individual bonds and ETFs, the individual investor's tax lots are taken into consideration to a much greater extent, and the decision to sell one of those lots stays at the individual account level.

Conclusion

Mutual funds, ETFs, and individual bonds are all important options for investors, but careful consideration of the various pros and cons must be contemplated when building a bond portfolio. In conclusion, there is no single answer when it comes to how to invest in bonds, and it is important to speak with your investment professional to determine which strategy may best fit your goals.

1. Wells Fargo and its affiliates are not legal or tax advisors. Be sure to consult your own legal or tax advisor before taking any action that may involve tax consequences.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income.

The investment return and principal value of a mutual fund will fluctuate and shares, when sold, may be worth more or less than their original cost.

Exchange-traded funds are subject to substantially the same risks as individual ownership of the securities would entail. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed, or sold, may be worth more or less than their original cost.

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