

## Bonds vs. Bond Funds: Which Is Better When Interest Rates Rise?

The Federal Reserve has said it expects to begin raising its target rate sometime in 2014. Since bond prices fall when interest rates rise, it may be a good time to pay increased attention to any fixed-income investments you have. Here are some factors to consider when you review your portfolio.

### Maturity dates and duration

One way to address the threat of rising rates is through maturity dates. Long-term bonds may pay a higher coupon rate than short-term bonds, but when rates rise, long-term bond values typically suffer more. That's because investors may be reluctant to tie up their money for long periods if they expect a bond's interest payments may suffer by comparison when newer bonds that pay higher rates are issued. The later a bond's maturity date, the greater the risk that its yield eventually will be surpassed by that of newer bonds.

A bond fund doesn't have a maturity date, and your shares may be worth more or less than you paid for them when you sell. However, there is another way to gauge the sensitivity of either a bond or a bond fund to interest rates: its duration, which takes into account not only maturity but also the value of future interest payments. The longer the duration, the more sensitive a security is to interest rate changes.

To estimate the impact of a rate change, simply multiply a security's duration by the percentage change in interest rates. For example, if interest rates rise by 1%, a bond or bond fund with a duration of 3 years could be expected to lose roughly 3% in value, while one with a 7-year duration might fall by 7%. (Though interest rates currently have little room to fall, the same principle would apply; a 1% decline in rates should result in a 3% gain for a bond fund with a 3-year duration.) Though this hypothetical example doesn't represent the return of any specific investment, you can apply the general principle to your own holdings.

### Diversification

Since rising rates affect most bonds, diversification provides only limited protection against rate increases. To balance yields with the threat of rising rates, you can diversify across various segments of the bond market (for example, investment-grade corporate, high-yield, Treasuries, foreign, short/intermediate/long-term, and municipal debt). Bonds don't respond uniformly to interest rate changes. The differences, or spreads, between the yields of various types can mean that some categories are under- or over-valued compared to others. Funds may offer greater diversification within each segment at a lower cost than individual bonds, providing greater protection against the impact of a potential default by a single issuer. However, diversification alone doesn't ensure a profit or prevent the possibility of loss, including loss of principal.

### Flexibility

Holding individual bonds allows you to sell a specific bond on your own timetable or hold it until it matures. That flexibility has two advantages. First, if you hold to maturity, unless a bond's issuer defaults, you know how much you'll receive when the principal is repaid. Rising interest rates may cause a bond's market value to fluctuate in the meantime, but if you hold it to maturity, that fluctuation may not be an issue for you, especially if predictable income is your highest priority.

Second, it can help you manage your tax liability; if a specific bond has lost value, you can sell it and declare the loss on your federal income tax return. You may be able to instruct your broker to sell specific shares of a bond fund to harvest losses for tax purposes, but in general it's more challenging to manage tax liability as precisely with bond funds. For example, capital gains or losses generated by a fund manager's trading are passed through to individual shareholders each year, which can affect your tax liability. Also, a bond fund's value can be affected by your fellow

investors. Since an open-end fund must redeem investors' shares daily, strong selling can force a fund to sell holdings to meet redemption demands, which can have implications for other shareholders.

Laddering individual bonds also can help provide flexibility to adjust to rising rates. Laddering involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As interest rates rise, each bond that matures can be reinvested in a newer instrument that offers a higher yield.

### Liquidity

A mutual fund will redeem your shares at the end of every business day. An individual bond traded on the open market may not have the same liquidity, and you could have difficulty finding a buyer who's willing to pay the asking price. However, individual bonds are priced and traded throughout the day; only closed-end funds and exchange-traded funds have that flexibility, not open-end mutual funds.



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