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Buying a Portfolio of Bonds: Making a Case for Investing in a Bond Fund

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One of the common questions that we receive at LGK Investments of Aligned Capital Partners Inc. is whether one should buy a portfolio of individual bonds or a bond fund. There is not a definitive answer to this question because there are many factors to consider. Let's look at what is required to effectively buy bonds at the individual level.

There are six key factors that an investor must consider when creating a bond portfolio. They are:

1. Diversification – Government (Federal, Provincial, Municipal), Corporate, High Yield, Real Return are all types of bonds required to create a meaningful portfolio. They can also have a term that lasts anywhere from 30 days to 30 years. The percentage weighting in each area will depend on the views of the investor and the research they've done. Detailing those considerations goes beyond the scope of this article.
2. Risk of Default – Bonds are rated based on their risk of default (i.e. the risk the borrower can't pay you back). Federal government bonds have a very low risk of default. High Yield Bonds can have a much higher risk. An investor must do their homework and diversify accordingly. Reading company financial statements or reviewing credit analysis done by companies such as Moodys or Standard & Poors are good examples.
3. Access – It is often difficult for an investor to get access to the same inventory of bonds that is available to a large bond fund manager such as a mutual fund. This has to do with the relationships that the bond fund manager has with other large bond portfolio managers, pension funds, banks and wealthy institutions, as well as the volume of transactions a typical bond fund manager does throughout the year.
4. Cost – Trading costs tend to be lower (as a percentage of trade size) for higher volume buyers and sellers of bonds. Minimizing costs by maximizing the size of each bond purchase will improve a portfolio's yield (yield = rate of return).
5. Liquidity – How much of the portfolio needs to be set aside for immediate liquidation in case of an emergency or for cost of living needs is a very important consideration for any investor.

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6. Tax Considerations – Bonds pay interest which is taxed at the highest marginal tax rate for investors. As a result, many investors will tend to hold bonds in their RRSPs rather than in a non-registered or corporate account so that all taxes may be deferred. An experienced bond investor can create capital gains or losses on the bond maturity date by buying a bond at a certain price above or below the maturity value of $100 (all bonds mature at $100). This can be a useful tax planning tool. They can also generate them through active trading strategies. Capital gains are taxed at half of what interest is taxed at.

Given the above considerations, properly designing a high-quality bond portfolio requires an extensive expertise and an immense commitment of time to research. Historically, there have been many instances where the investor buying individual bonds has ended up undiversified, with inadequate exposure to the breadth and depth of the overall bond market. In addition, commissions charged on bond purchases are often not transparent. They are calculated into the price of the bond and that affects the yield and ultimate rate of return. These commissions at times can be quite costly.

So why buy a bond fund? Because a good bond fund manager will do "all of the above" for you and they will do it very well. Yes, they charge a fee for doing so, but isn't the peace of mind worth it?

Listed bond funds package together many of the benefits discussed and, in that regard, we at LGK Investments of Aligned Capital Partners Inc., often consider them as an appropriate solution for satisfying the fixed income component of a portfolio.

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