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Investigate bond strategy carefully

With bond yields at 40-year lows, we have questioned investors' passionate embrace of bonds. Regardless, we believe that investing in the bond market deserves thoughtful consideration. The differences in products and approaches are significant.

PERSONAL FINANCE

RICHARD TODD

For institutional managers, including mutual funds can take advantage of yield-curve changes, yield differences between segments, and interest rate movements to enhance portfolio returns. Individual bond investors can't be opportunistic because of the pricing inefficiencies for non-institutional investors.

We recently evaluated a portfolio valued at nearly $10 million and found that the spread (the difference between the market value of the bonds and what was actually paid including commissions) averaged over 2 percent upon portfolio implementation by a broker. Institutions offer access and pricing advantages that brokers can't touch. Size matters in the bond market — generally, the bigger, the better.

Understand the direct correlation between fees and performance with bond funds. Generally, the worst-performing bond funds have higher internal expenses and the best-performing products have low expenses. The median bond fund has an internal expense of 0.62 percent. If your investment grade bond fund has an internal expense greater than average, find another product.

Know that strategies and risks vary. In 2002, a number of "investment grade"

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bond products were slammed due to an over-concentration in telecom and airline bonds. They had significant risk exposure to credit and lacked the diversification of the Lehman indexes.

Further, high-yield (or "junk") bonds performed poorly and bond defaults were at record levels in 2002. Junk bond characteristics can be more like equities than investment grade bonds and can be an opportunity at times, but are much more aggressive.

Consider "plus" products. These managers will have 80 to 90 percent of their portfolios similar to the Lehman indexes, but will allocate the balance in opportunistic areas such as non-U.S. bond or high yield.

Focused research can identify strategies that can improve results, and are in a much better evaluation position to analyze these aggressive areas than an investor, broker or planner.

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