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Mutual Funds—Bond Funds

A bond mutual fund is a professionally managed portfolio of bonds. You purchase shares in the fund. The large number of bonds held in the fund provides you with a diversified investment and minimizes your investment risk. The fund manager buys and sells bonds according to the investment objective of the fund.

- There are many different types of bond funds: government bond funds, corporate bond funds, funds with short-term bonds (1–3 years), medium-term bonds (3–7 years), and long-term bonds (7 or more years). Prices for most large bond funds are published daily in newspapers.
- The value of your shares in the bond fund fluctuates depending on market conditions. Unlike individual bonds, you are not promised a fixed value at maturity.
- Bond funds pass interest through to the shareholders, and this income is taxable to you even though you may elect to reinvest the interest. Also, profits from the sale of some of the bonds in the portfolio are passed through as capital-gain distributions.
- You can buy bond funds directly from a mutual fund company or through discount brokers and brokerage houses.

Advantages

- Easy to purchase. You can open an account with a minimum investment—usually $500 to $3,000. You can sell part of your investment as needed and allow the remainder to grow. Many bond funds provide you with checks so you can write a check against your account when you need the money.
- Once opened, you can add money to bond funds in increments as small as $25 a month.
- Your investment income can be automatically reinvested.
- You receive professional management. Because of the large number of bonds held in the funds, you have a more diversified portfolio than if you purchased individual bonds.
- The investment return (measured by the interest income and appreciation of the bonds in the fund) is often higher than you receive with savings accounts or money market funds.
- For people in high tax brackets, there are federally tax-free municipal bond funds, and single-state municipal bond funds that are free from federal and state taxes.

Disadvantages

- The value of your investment will fluctuate depending on the market environment so there will be periods where a bond fund will have a lower rate of return than a savings account or a CD. Long-term bond funds are particularly sensitive to interest-rate changes. The values of bonds move in inverse relation to interest rates. The value of a long-term bond fund will go down if interest rates rise, while intermediate bond funds will go down less and short-term bond funds will go down the least. As a trade-off for this type of market risk, long-term bond funds usually pay higher interest rates.

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- Unlike dividends and capital gains, interest income is taxed at ordinary income tax rates.
- You pay a yearly management fee to the mutual fund. This reduces the return that is passed on to you as a shareholder. This fee can be avoided if you purchase individual bonds.
- Some bond funds charge a sales commission at purchase, or a deferred sales commission if you sell your shares before a certain length of time; however, there are many bond funds that have no sales commissions—no-load funds.
- You do not control the taxable distributions paid from the fund. In addition to interest, if the manager of the fund buys and sells a lot of bonds, you may receive a capital-gains distribution. You pay tax on the interest and capital gains even if you choose to reinvest your earnings by purchasing additional shares of the fund.

Best Use for College Savings

Bond funds are an easy way to build a college fund. If you reinvest your earnings, you often get a higher return than from CDs or individual bonds. You can set up an automatic investment plan with a mutual fund company where a specific amount is transferred from your checking account into the bond fund each month. Because the value of the fund can fluctuate, a good strategy is to move funds from a bond fund to a CD or savings account (or a money market account within the same "fund family" that operates the bond fund) at least two years before the cash is needed.

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