Fidelity, Vanguard Choices Continue Steady Upward Climb

Bond Funds: No Flash, No Frills, Just Results

by Danielle L. Schultz, CFP

Many BetterInvesting investors are aware of the advice to balance stocks with investments in other areas of the investing universe. The most common reason for recommending this is the stabilizing effect diversification has on the total return of the investment portfolio. An investment in bonds is the classic way to balance the volatility of a portfolio that has a significant commitment to stocks.

Bonds are the Steady Eddies of the investing world. A good bond is boring, with a fairly stable price and dividends that are dependably paid, year after year. Individual bonds are selected to create a predictable income stream and safety: Good quality bonds held to maturity will return the initial investment.

But investing in individual bonds carries some difficulties. Bonds aren't traded through organized exchanges — there's no official New York Bond Exchange. They can be more difficult to purchase (the brokerage must have a reliable bond desk) and sell, and prices and bid/ask spreads of individual bonds can vary, depending on how the trading is handled.

Also, owning individual bonds freezes the return at a moment in time, so that if interest rates change substantially during the period of an individual bond, the long-term bond holder can really suffer. Ask anyone who was holding a 40-year, 4 percent bond in the 1980s, when money-market rates climbed to 13 percent or more. And, as interest rates rise, the market price of the bond will dip, making bailing out costly before maturity. Also, individual bonds can go into default, as some owners of municipal bonds have discovered recently.

For many investors, a bond fund can be the easiest way to add bonds to a portfolio.

Two choices available to many investors, either individually or as part of many workplace retirement funds, are the **Fidelity Total Bond Fund (FTBFX)** and **Vanguard Total Bond Market Index Fund (VBMFX** for Investor-class shares; **VBTLX**, the Admiral class, requires a $10,000 minimum investment). Because bond funds pay dividends but rarely capital gains, it's usually better to hold them in tax-deferred or tax-free accounts — such as IRAs, 401(k)s or Roths — to minimize tax impact.

Because bond funds own thousands of individual bonds, the investor is shielded from the impact of a default of any single investment. Dividends received can be reinvested (rather than paid in cash as with individual bonds), maintaining the portfolio's allocation to this sector. A professional manager can generally achieve the best execution of trades, often at lower cost than an individual might obtain. And, if an investor chooses a total bond market fund, the fund will diversify across short-, intermediate- and long-term bonds, and government and corporate issues — much more variety than most investors could purchase on their own.

Many people rely on Morningstar's ratings to help with fund selection. Morningstar has recently introduced a new rating system (Gold, Silver and Bronze), which reflects their analysts' assessment of the future potential of a fund. Both of these funds are rated Gold. Morningstar's star system, a measure of how well funds have performed in the past, gives the Fidelity fund four stars and the Vanguard, three stars.

Investing Philosophy

Although at first glance the names of these funds might lead you to believe that they should be virtually identical, in fact they're quite different. The Fidelity Total Bond Fund is actively managed, with the managers free to make adjustments to the fund depending on their analysis of current and future market trends. Notice that the word "market" is missing from Fidelity — it's primarily bonds, but the managers can choose the types and terms, as well as select some portion in other instruments.

In fact, about 7.5 percent of funds are currently being held in cash and short-term instruments. Presumably in a bid to increase returns, this fund holds bonds of lower quality, with an average credit rating of BBB, the lowest investment grade. Measuring the fund against its appropriate benchmark, the BarCap U.S. Aggregate Bond, gives an R-squared of 45, which means that movements in FTBFX are because of movements in the index only about 45 percent of the time. (*For more on the concept of R-squared, see page 28.*) Much more of this fund's performance is due to the judgment of management.

In contrast, the Vanguard Total Bond Market Index is a passively managed fund, which means the managers seek to mirror the index as much as possible. The index used is the Barclays Capital U.S. Aggregate Float Adjusted Index. This is a slightly different benchmark from FTBFX, but in general there's been little difference in performance between the two. No bond manager can precisely replicate an index because of the difficulty of purchasing exactly the same bonds, so Vanguard managers have attempted to match their index by choosing bonds of similar quality and duration. The R-squared of this fund is 98, indicating they've matched the index 98 percent of the time. VBTLX has a much higher percentage of assets in U.S. Treasuries — 36 percent versus 24 percent for Fidelity — and the average credit rating is AA. Although this is an indication of greater safety overall, it'll also produce lower yields.

Portfolio and Management

Fidelity Total Bond has been managed since 2004 by Ford O'Neil, who manages a range of Fidelity accounts, along with a team of 39 analysts in the bond and money-market areas. These analysts specialize in specific areas: junk bonds, mortgage, bank loans, etc. Since O'Neil is seeking to beat the index by his investment choices, he draws on Fidelity's deep bench of expertise.

Ken Volpert has been the manager for VBTLX since 1992. In April 2008, Greg Davis was named co-manager. All of Vanguard's fixed-income index funds are managed by a team of six portfolio managers and six traders. Volpert's mission is to duplicate his index and he's reliably done so.

Performance and Costs

VBMFX has been around longer than FTBFX, so charts showing total performance can be somewhat misleading. If we adjust results to measure the same time period (Oct. 15, 2002 to Nov. 30, 2011), the results of a $10,000 investment are $16,086 for Vanguard and $16,866 for Fidelity, based on Morningstar's tools.

Although both funds have relatively low expenses (0.45 percent for Fidelity and 0.22 percent for Vanguard Investor class), investors can obtain even lower costs (0.11 percent) if they invest a minimum of $10,000 to be eligible for Vanguard's Admiral shares or purchase the exchange-traded fund (BND), which at Vanguard is treated as another share class of the mutual fund.

But investors in bond funds may want to examine how closely the ETF is tracking the fund's net asset value. During periods of extreme market volatility, some significant gaps have occurred in bond ETFs.

Caveats

Although these bond funds took a hit during 2009, as did practically every other investment, their value never plunged to the degree that many stocks and stock funds did. Indeed, an account with $10,000 invested in 2002 would still have been in positive territory during 2009, although value would have slipped compared with 2008 values.

Since 2009, these funds have recovered and continued their steady march upward. Over the long term, stocks can be expected to outperform bonds, but in the most recent plunge and our slow recovery, the bond sector has served its function as insurance against stock volatility.

Money has flooded into bond funds lately, as investors have sought a better return than stock funds have offered. But there's danger that investors are again buying fashionable investments at market highs. Should interest rates increase, most bond funds would likely see share prices drop. In the event of a rise in interest rates, however, fund managers can adjust future purchases to take advantage of then-available higher yields, which tends to even out the intense swings compared with what we see in equities or the popular sector du jour.

When choosing between these funds, investors should consider that the Vanguard fund has a longer duration — 5.1 years versus 4.3 years for Fidelity — and will be more vulnerable to changes in interest rates. Either of these funds could be solid choices for the bond sector of a portfolio. Depending on your view of active versus passive management, your sense of when interest rates may change and choices available in workplace accounts, one or the other of these should emerge as a frontrunner candidate for your investment portfolio. BI

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Comparing Fidelity and Vanguard Bond Options

	Duration	Avg. Credit Quality	Management fee
Fidelity Total Bond	4.3 years	BBB	0.45%
Vanguard Total Bond Market Index	5.1 years	AA	0.22%, 0.11% Admiral class

Source: Morningstar

	1 yr. (%)	3 yr. (%)	5 yr. (%)	10 yr. (%)	Since inception (%)	Yield (%)
Fidelity Total Bond	5.48%	12.54%	6.19%	N.A.%	5.89%	3.6%
Vanguard Total Bond Market Index Inv	5.19	7.42	6.05	5.31	6.82	3.1
Vanguard Total Bond Market Index Adm	5.31	7.54	6.15	5.41	5.23	3.2

Source: Morningstar. Note: Morningstar adjusts return rates for management costs and may differ from returns reported by the mutual fund. The difference management costs can make is easily seen by comparing rates for Vanguard's Investor and Admiral share classes. Data as of Nov. 30, 2011.

	Fidelity Total Bond (FTBFX) (%)	Vanguard Total Bond Market Index (VBMFX) (%)
U.S. Treasuries	24%	38%
TIPS	4	0
U.S. Agency	6	7
Mortgage Pass-Throughs	20	27
Mortgage CMO	8	2
U.S. Corporate	26	18
Asset-Backed	2	0
Municipal	0	1
Foreign Corporate	7	5
Foreign Government	2	2

Source: Morningstar

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