How to Tell if Bond Funds are Right for You or Not

All too often people who have successfully invested in stock funds assume that tax free bond funds would be right for them. But that might not be the right investment for you because tax free bond funds are totally different from stock funds. Fortunately there are two qualifying questions you can ask yourself to decide if the one size fits all bond funds are a good fit for you. This educational article explains how to decide.

This report does not include any references to money market funds which are generally used for temporary placements of capital. This educational report is designed to help investors decide whether or not longer-term bond funds are suitable for them.

As specialists in municipal bonds for the individual investor, Stoever Glass account representatives are frequently asked questions concerning tax-exempt trusts-or "municipal bond funds" as they are often called. Investors would like to know which funds are the best investments for them. And, they want to know if they should invest in long-term bond funds.

For over 50 years, Stoever Glass has been telling investors that one of the most important things to know about tax-free investments is how to select the investment best suited to one's specific needs and goals. We try to show investors how to determine their investment perimeters and suggest the investments, which will offer the best combination of safety, liquidity and return to meet their investment goals. Still, we agree that the one-size-fits all investment fits some investors. And fortunately, there's an easy way to tell if long term bond funds may be suitable for you.

Should You Choose Long Term Bond Funds?

Anyone considering bond funds should ask themselves two qualifying questions before deciding to invest. The first qualifying question is: Are long-term current-income bonds better for you than short-term bonds? When you buy shares of these bond funds you're actually buying long-term bonds. And as we have illustrated so often, the longevity of the term-the element which gives long-term bonds their attractive current yields--is also the element which makes them more vulnerable to market price fluctuations. That means you could get hurt if you have to sell when the market is off. In contrast short-term bonds pay less but they protect your principal against market fluctuations much better. That's why you should consider long-term funds only when the high return a long-term package of bonds offers is more important to you than safety of principal--when defined as liquidity at or near the price you paid. That's when long-term bonds or the funds which package them are better for you than the shorter-term alternatives.

To give you a better idea of what we mean, an example of someone who should probably not buy long-term bond funds would be a businessperson in their forties or fifties, earning $200,000 or more per year. Since they're already earning a high salary, the better protection of principal that shorter bonds offer should be more important to them than the high current income a long-term bond offers. For most retired investors, who expect to leave the bonds in their estate, the extra current return of long bonds would be a means of enhancing their lifestyle. So for them, the higher current income might be more important.

With this distinction in mind, ask yourself if your goals and circumstances suggest that a higher return is more important to you than liquidity of your principal at or near the price you paid. If not, you can stop reading right here. The funds are not for you.

For those who should still be reading, here is the second qualifying question: Do you have a total of $100,000 or more to invest?

Quite frankly, if you do, we will continue to try to dissuade you from purchasing funds. That's because funds are simply another method to get the diversity you have sufficient means to get on your own. Most people don't realize that some funds contain only 10-15 different issues. So an investor with a total of $100,000 to invest is already in position to put together a diversified portfolio of individual bonds. Remember, the funds charge a fee for their "packaging" services. Obviously, the more you have to invest, the more you can diversify on your own, and the less reason there is to pay extra to get diversification. So, in conclusion, bond funds are most suitable for those investors with less than a total of $100,000 to invest, and who find that long-term in bonds best suit their needs.

The Advantages of Bond Funds

While there are choices to be made within each category, unit trusts fall neatly into one of four basic categories--national or single state; and either insured or uninsured. As the names imply, national funds consist of issues from a variety of states while single state funds contain bonds of a single state and with it, the exemption of income from their state's taxes as well as federal taxes.

The first advantage is that they offer the smaller investor, a chance to get diversification similar to that which larger investors can achieve by purchasing bonds individually. And while the fund investor cannot pick and choose the issues, maturity dates, or interest amounts independently, the funds maintain certain minimum quality levels.

Another advantage shared by most funds is that they offer investors a monthly payment plan for receiving interest income. Instead of a semi-annual interest payment, the investor can opt for a monthly check. This option is clearly an extra benefit for retired persons or for any investor whose main concern is current income. So we think it's a very worthwhile feature.

Many funds offer investors an option to automatically re-invest interest payments but if current income is not a concern, this should set off a warning signal. After all, if current income is not a concern, you probably should not be buying long term funds in the first place. This re-investment option is contradictory to the purpose of the fund and therefore we do not recommend it, because if you are not concerned with current income, you are probably better off with shorter term bonds which offer better protection of your principal against market fluctuations.

Insured or Uninsured?

The insured funds, whether national or single state, offer the extra security of insurance which backs the fund. This is an attractive feature for those investors who don't feel comfortable with bonds which are A-rated but, still like the other advantages funds offer. Of course you give up some current return for this added security.

Uninsured funds, on the other hand, are for investors who place more emphasis on yield, and feel sufficiently secure with an "A-rated" diversified portfolio.

National or Single-State?

If you live in a high-tax state such as New York, New Jersey, Massachusetts or California, you can't beat the extra benefit of double, and sometimes triple tax-exemption of the single state funds. Where individual state and local taxes are minimal or nonexistent, such as in Florida, Texas or Washington, national funds are the best choice.

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A Word of Caution Regarding Long-Term Bond Funds

Bond funds have no specific maturity which means you may have to sell if you need your money sometime in the future. Of course, if interest rates have risen when you want to sell that will probably result in a loss for you. Also, if sufficient fund investors rush to sell at the same time, as has happened occasionally, the fund may be forced to sell a portion of your shares at a lower price. Individual bonds might be more suitable because you can select a bond that matures when you think you'll need your money. Long-term bond funds are more suitable for people who don't plan to spend the principal in their lifetime, but plan to leave it in their estate instead.

And whatever you do, never ever buy a long-term bond fund unless you know the SEC yield which is your yield to an approximated maturity---your true yield. Too often investors are quoted only the current yield which is not your true yield. For example, recently we heard of an incidence where a potential investor was quoted a 4 1/2 % yield which of course was the current yield. When they insisted upon seeing the SEC yield, they were shocked to see the difference.

Although the above information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate.