Financial Focus: Explore different options when purchasing bonds

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June 16, 2011 - As an investor, you may find that bonds can be a valuable part of your holdings. But there's more than one way to own bonds, so you'll want to be familiar with the various investment vehicles available -- because the more you know, the better the choices you'll be able to make.

So, let's look at three popular ways of owning bonds:

Individual bonds --When you buy an individual bond, you will receive predictable interest payments. And when your bond matures, you'll get the original principal back, unless the issuer defaults, which is not common in cases of "investment grade" bonds. However, the value of your bond -- the price you could get for it if you sold it on the open market before it matured -- will fluctuate over time, primarily in response to interest rates. (When market rates go up, the value of your bond drops, and vice versa.) In general, you'll pay at least $5,000 for an individual bond, though that amount may vary. Consequently, while this approach gives you more control, it can be more time consuming and require a larger investment in order to build a diverse fixed-income portfolio.

Bond funds -- By investing in a bond-based mutual fund, which may own dozens of different types of bonds, you can efficiently increase your diversification, which is important, because diversification can help reducecredit risk (although it can't guarantee a profit or protect against a loss). A bond fund does not pay you a fixed rate of return; instead, you receive dividends, which will fluctuate based on the underlying bonds' interest rates and capital appreciation. In addition, bond funds don't have a maturity date when principal is repaid. Keep in mind that when you purchase bond funds, you could be subject to capital gains taxes in two different ways: if you sell your fund shares for a profit or if the fund manager sells an underlying bond for more than it's worth. This increased capital gains liability is one reason that many people put bond funds in a tax-deferred vehicle, such as an IRA or a 401(k).

Bond UITs --A unit investment trust (UIT),like a mutual fund, contains a variety of bonds, so you get the benefit of diversification. Unlike a mutual fund, however, a UIT is not actively managed and does not change its holdings. And since no manager is involved in making changes or trades, a UIT has low management fees. A UIT is typically established for 20 to 30 years, but, as an individual investor, you can sell your shares whenever you want, for whatever the market will bear.

Although UITs can be some of the most cost-efficient, low-risk options in the fixed-income arena, they are not without risk. Specifically, since a UIT's bonds provide fixed interest rates, there's always the possibility that the bonds will lose purchasing power to inflation over time.

When choosing how to own bonds, you'll need to evaluate many factors -- and we've only looked at some of them. You may want to consult with a financial advisor to determine which methods of bond ownership are appropriate for your needs. By doing your homework, and getting the help you need, you can maximize the advantages of adding bonds to your investment mix.

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