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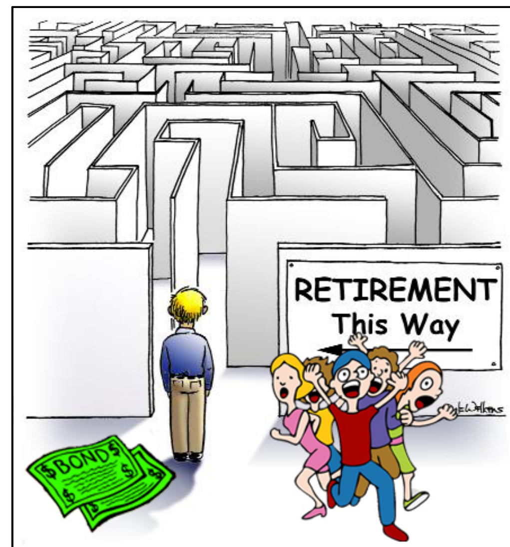
Avoid (most) bond index funds like the plague

"My problem lies in reconciling my gross habits with my net income." Errol Flynn, American film actor (1909 – 1959)

Navigating the Retirement Maze



Index funds have captured the attention – and much of the assets – of the American investor. During his lifetime, John Bogle preached the virtues of low investment fees and passive investment funds, and investors finally seemed to get the message. Index funds now account for nearly half of US stock fund assets. Actively managed funds, which almost always have higher management fees due to the cost of investment teams, have struggled the past decade to match the performance of the index funds, and in many cases have become "closet indexers" in order to improve their relative performance. (Note: As I pointed out in my May 2017 article entitled "Why Indexing Doesn't Always Work," the growth in index funds has made their outperformance a self-fulfilling prophecy, which probably will rapidly reverse when investors exit these funds en masse in the event of a market downturn.)

While most of the attention has been given to US equity index funds, there has also been substantial investment in bond index funds. The attraction is like that of stock index funds: low fees and performance that matches or beats most actively managed bond funds. In fact, many target date funds use bond index funds for their income allocations.

I am in favor of using low-cost funds when appropriate. However, the problem with using index funds without understanding the underlying methodology and structure of these funds is that they can be a recipe for financial disaster, particularly in the current investment environment. As I pointed out in my earlier article about indexing, these funds work well most of the time… except when they don't, and we presently have a market setup for the latter scenario. Bond index funds particularly concern me, and I assiduously avoid using them for client portfolios with one notable exception. I'll explain the construction of bond index funds, the risks inherent in them, and the one exception to my rule.

The anatomy of a bond index fund

Index funds, true to their name, attempt to passively replicate a specific financial index. Most of the assets invested in US stock index funds, which includes ETFs, track the S&P 500 and the NASDAQ indices. Both of these indices are "cap-weighted," meaning that the allocation of a particular stock in the fund is proportional to the market capitalization (i.e., the dollar value of all shares outstanding) of the stock. Thus, stocks like Microsoft, Apple, Google, and Facebook occupy large percentages of these indices, and in the index funds that replicate them.

Cap weighting is easier to manage than other weighting approaches and thus tends to be favored by index fund sponsors. Of the 230 passive bond ETFs, 220 are cap-weighted. So, what's wrong with bond fund cap weighting? For starters, you get the biggest allocation to the companies with the most outstanding debt. With equity, market cap is an indication of company strength and popularity. With bond funds, cap-weighting allocate more debt from companies that tend to be the most highly leveraged, which can have adverse

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consequences in the event of a recession or bank credit contraction. The most successful companies, or those with the most debt: which would you rather have more of in your fund?

The "Triple-B" problem

When the market crashed in 2008-2009, one way that the Federal Reserve bailed out financial institutions was by drastically reducing their interest rate for overnight borrowing by banks. This, together with the recession, led to lower interest rates across all bond maturities. The low rates persisted for years, leading many companies to load up on low cost debt, resulting today in the highest amount of corporate debt in history. Coupled with this growth in corporate debt was a relaxation of borrowing standards, called "covenant lite" loans, as well as more loans being made to marginally profitable (low rated) companies.

In 1992, only 25 percent of the dollar value of investment grade bonds – those rated BBB- or higher by Standard & Poor's – were at the BBB level, one downgrade away from "junk bond" grade. Today, it has risen to over 50 percent. The two largest US bond ETFs, holding a combined $100 billion in assets, have one-third of their holdings rated BBB or unrated. Many ETFs and index mutual funds holding only investment grade corporate debt have over 50 percent of their assets in BBB-rated bonds.

In strong economies and with low bond interest rates, companies with lower ratings can usually make their interest payments and maintain their investment grade status. However, in the event of either a recession or needing to refinance their expiring bonds at higher interest rates, those same companies may face the prospect of having their debt downgraded to junk status, forcing bond funds that are mandated to hold only investment grade debt to dump these holdings. Unlike the stock market, where billions of shares change hands through the major exchanges each day, the bond market tends to be a lot less liquid. Thus, a forced sale of bonds due to a downgrade or high fund redemption requests can force bond funds to sell shares at prices well below their intrinsic value, resulting in substantial losses for investors.

The alternative and the exception

Thus, when investing my clients' assets in bond funds, I prefer to find the best performing bond fund managers and then be prepared to pay more in management fees for their expertise. Both research and experience has proven me right in this regard. There is one exception to my "only actively managed bond fund" rule, and that is passive bond index funds that invest only in US government Treasuries. All their holdings are rated AAA with no default risk, so I search for the least expensive bond ETF that hold Treasuries with the maturities that I am seeking. In this instance, cheaper really is better. But for the rest of bond index funds, I fear that during the next recession, investors really will get what they paid for: no fund oversight and significant default risk.

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