Seven Reasons Why Advisors Should Use Bond Ladders

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by Larry Swedroe

I often hear criticisms from the financial media and professional advisors about the use of bond ladders. Whenever the criticism comes from professional advisors, however, I've noticed it generally involves firms that use only bond mutual funds or ETFs instead of individual, tailored bond portfolios, whether in the form of a bond ladder or not. Unfortunately, much – if not all – of this criticism is based on falsehoods and the conflicts that can arise when advisors employ only mutual funds and ETFs.

An investor brought to my attention a piece that restated many of the old canards about bond ladders. This article is one of many. Even highly regarded finance columnists like Jane Quinn have taken laddered bond portfolios to task.

To correct the misperceptions, I'll address each of the criticisms typically raised, beginning with credit risk.

1. **Credit risk and the need for diversification**

It's true that one of the greatest benefits of mutual funds is diversification, which is critical for investments that contain a lot of idiosyncratic risk, like stocks and junk bonds. However, with Treasury bonds and FDIC-insured CDs, there's no need to diversify, because there isn't any credit risk.

With corporate bonds, because of the risk of default, there is a need to diversify. Thus, for these assets, mutual funds should be the preferred choice. However, with municipal bonds, if one limits their holdings to AAA/AA and only general obligation (GO) and essential service revenue bonds (the bond types recommended in my book, The Only Guide to a Winning Bond Strategy You'll Ever Need), the need for diversification is greatly reduced because there is little credit risk (almost all of the risk in these bonds is term risk).

For example, since 1970, losses from default on these types of bonds have been virtually zero, and that includes a period spanning several recessions and the latest severe financial crisis.

In fact, credit quality will be higher (likely significantly higher) through a ladder of individual AAA/AA general obligation or essential service revenue bonds than it will with almost any municipal bond fund, and certainly higher than with popular Vanguard funds.

For example, Vanguard's Intermediate-Term Tax-Exempt Fund (VWITX) has about 25% of its portfolio invested in credit rated below AA. And about 7% of the bonds held in the fund are either below A or unrated. So, even though VWITX does have a more diversified portfolio than an individual investor holding a bond ladder would, the holdings are also clearly riskier, requiring that greater diversification.

That's one canard down.

2. **High cost of implementation and maintenance**

The argument that laddered bond portfolios have high implementation and/or maintenance costs goes something like this: "Individual investors who trade bonds pay very high costs compared with institutional investors." However, there are a few problems with this assertion.

First, one can buy Treasury bonds at issuance directly from the U.S. Treasury at the very same prices institutional investors obtain. What's more, there are online services where you can check prices, which are highly transparent. Second, with FDIC-insured CDs, not only are there little to no trading costs, yields can be much higher than they are on Treasurys.

For example, the yield on five-year Treasurys is just 1.8%. Five-year CDs are available yielding 2% or more. That's a difference of at least 20 basis points, even before taking into account mutual fund expenses. If you own a bond fund, you then have to subtract its expense ratio, making your return even less. In addition, mutual funds cannot buy CDs. This is a huge disadvantage for investors when they limit their investments to mutual funds.

Returning to the issue of trading costs, the point about individual investors paying very high costs compared with institutional investors is generally correct if you are an individual buying municipal bonds (or corporate bonds, which I'd recommend you avoid) in the secondary market, not the primary (new-issue) market. In the primary market, all investors get the same pricing.

Because the secondary markets in municipal and corporate bonds are less transparent, individuals buying on their own through broker-dealers can pay large markups, which can range from about 1% to as much as 6%. Therefore, this practice should be avoided. Instead, individuals buying municipal bonds on their own should limit purchases to new issues, which, as mentioned, are sold to all investors at the same price.

However, a Registered Investment Advisor like my firm, which buys several billion dollars' worth of bonds a year, is able to obtain the same type of pricing that institutional investors like Vanguard get by putting broker-dealers into competition with each other. Markups average just 0.1-0.2% in price (dealers are entitled to make some profit), which, for a bond ladder with an average maturity of five years, would be only about 0.02-0.04% in yield.

In addition, while an institutional investor wouldn't be interested in buying a small lot (say, $25,000 or $50,000), RIAs that create bond ladders can buy such bonds, which typically have the advantage of trading at higher yields for those willing to be providers of liquidity by being patient buyers.

RIAs that use laddered bond portfolios are often able to buy smaller lots at prices often well below (not above, as the aforementioned article would lead you to believe) the prices paid for large lots. Incremental yields are frequently in the neighborhood of 0.30%, or even well above that. And of course, the investor is avoiding the cost of the mutual fund or ETF. That's two canards down.

3. **Lack of transparent data on performance**

This is a strange criticism, because any advisor should be required to provide performance data, whether they build portfolios with individual bonds or mutual funds. And there is no reason that information cannot be provided. For example, quarterly reports can show a client's performance for the period, year-to-date and since inception. It can also show the current credit rating of each bond in the portfolio. Another canard exposed.

4. **Lack of clear direction on how best to implement a ladder**

Quoting from an article by one advisory firm: "Even though it has the appearance of a passive strategy in its strict adherence to buy-and-hold, it is in reality active because it puts the investor (or her broker/advisor) into the position of being a bond-picker. Deciding which company's or municipality's bonds to favor at the expense of all the others is vexingly difficult, if not impossible, for all but seasoned professional bond managers, and even they fall short of passive benchmarks more often than not, according to the Standard and Poor's Index vs. Active Funds Scorecard."

This is yet another canard. The reason is that the highest-quality municipal bonds of the same maturity tend to perform virtually identically because there have been virtually no credit losses. For example, a GO bond rated AAA from a municipality in Missouri will perform virtually identically to another GO bond rated AAA from a different municipality. The active managers underperform because of their expenses and trading costs, not because they cannot pick the right bonds.

In addition, there aren't really any pure municipal bond index funds (since there are far too many issues, many of which are small). Thus, all mutual funds are individual bond pickers according to the critique. This clearly demonstrates that it's just another smokescreen.

5. **Bond ladders force you to reinvest at lower rates**

It's true that bond funds allow investors to conveniently reinvest interest, which is an advantage. However, the mistake here is in thinking the world is black or white (either all individual bonds or all mutual funds). Someone who owns an individual bond ladder can also hold a bond fund with roughly the same average maturity as their ladder, and move any interest payments to the bond fund until they have sufficient assets to purchase another individual bond to extend the ladder.

What this also fails to account for is that municipal bond funds themselves typically hold some cash. For example, Morningstar shows that the Vanguard Intermediate-Term Tax-Exempt Fund (VWITX) might hold up to 5 to 6% of its assets in cash (1.8% as of June 30, 2017).

6. **Bond ladders deprive you of future capital gains**

The idea behind this argument is that, when you hold individual bonds and interest rates decline, your bonds will rise in market value. They will become worth more than you paid for them. But in ladders, you hold bonds to maturity, so you'll never collect the capital gains. In a mutual fund, the manager will harvest those gains and add them to your share value.

This shows a lack of understanding of how bonds work. You cannot change the nature of the risk associated with your bonds by the form in which you choose to hold them. A bond fund with an average duration of five years has exactly the same risk profile as a bond ladder with an average duration of five years. The reality is that an interest rate move will cause the portfolio’s value to rise (or fall) by the same amount, whether your holdings are a fund or a ladder. And if the bond manager harvests a gain, he must then reinvest the money at a now lower rate, leaving the fund in the same position (with the exception of having incurred trading costs).

7. **Bond ladders leave you unprepared for emergencies**

It’s true that a bond fund offers the benefits of liquidity (the ability to sell assets quickly without incurring large costs). However, this again is not simply a black and white issue. Investors who build ladders should keep a reserve for liquidity/emergencies. One widely used rule of thumb is to have six months’ spending needs in a liquid bond fund. However, for obvious reasons, any such fund should have a maturity that is relatively short term in nature.

Larry Swedroe is the director of research for the BAM Alliance, a community of more than 150 independent registered investment advisors throughout the country.

