Choosing Between Baskets and Individual Bonds

Bond exposure can be gained through individual bonds or unitized products (mutual funds or ETFs), with both options having benefits and drawbacks.

Diversification

Unitized products: Tends to be an efficient, low-cost solution where a small fee is paid to receive a basket of issues, providing ample diversification quickly.

Individual bonds: May require more capital to achieve diversification with higher minimums to investment. Account fee structures may introduce cost differences as well.

Transparency

Unitized products: Can be lower with holdings published periodically. Pricing is more transparent as they are listed on exchanges (ETFs) or have a daily NAV (mutual funds).

Individual bonds: When held directly, each bond is a separate line item, giving you full transparency to your holdings and their individual contribution to returns. However, determining prices require more involvement.

Maturity

Unitized products: The majority of bond ETFs and mutual funds do not have a final maturity date, meaning you would need to sell to raise cash.

Individual bonds: Bonds have a final maturity date, where you receive the bond’s principal, or par value, barring default. Even if the bond experiences volatility during its life, one can expect to see principal returned when the security matures.

Expertise

Unitized products: Purchasing active strategies run by professional bond managers could benefit investors, especially in niche areas like foreign markets or high yield.

Individual bonds: Many financial advisors / portfolio managers have experience in fixed income or can consult internal experts to construct portfolios that suit your needs.

Customization

Unitized products: ETFs and mutual funds cannot be customized by the purchaser. However, some products specialize in areas such as credit exposure, country, or duration.

Individual bonds: Highly customizable. Using bonds may more closely match desired maturity and level of safety.

Yield Quotation

Unitized products: ETFs and mutual funds often quote a distribution yield, which is more similar to the dividend yield on a stock and could include return of capital in addition to the values that make up the yield on a bond.

Individual bonds: Yield to maturity calculations include both the bond’s coupon payments as well as the movement between the purchase price and par.

This is a very important distinction as it can greatly affect the final return of the product and means the values cannot be compared directly – although both are yields, they are not calculated using the same inputs.

Liquidity

In periods of extreme uncertainty, almost all securities experience increased volatility. This is true for ETFs, mutual funds, and individual bonds.

Unitized products: ETFs can experience fluctuations in value or a widening of bid-ask spreads, but markets tend to be maintained during times of stress.

Individual bonds: Individuals who look to fixed income purely for safety should consider higher quality issues such as Government of Canada or Provincial securities as they maintain superior liquidity in trying situations. When situations are at their worst, market-makers may not provide reasonable markets to trade in.

Before adding fixed income to your portfolio, remind yourself of differences between investment vehicles. These factors may inform if individual fixed income securities, or a unitized product, is most appropriate.