Defined-Maturity Funds: A Bond Alternative With Compromises

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Interested in the benefits that individual bonds can offer, but not ready for the complications? The hybrid defined-maturity bond funds are one alternative. What are they and what do you need to know before investing?

As the name implies, defined-maturity bonds cease their existence on a specified date. At maturity, investors receive a distribution equivalent to the fund's net asset value. These funds are intended to be a solution for investors who desire certainty over the timing of cash flows or wish to stagger their interest rate exposure, but do not want to invest in individual bonds. Since these are funds, however, they come with compromises that should be understood and considered before purchase.

Bonds Versus Bond Funds

The underlying premise for defined-maturity bonds lies in the key differences between bonds and bond funds: maturity versus perpetuity. Bonds cease to exist at maturity while bond funds are designed to last into perpetuity. The difference affects the return of capital an investor can expect at the time he makes an investment.

A bond is essentially a loan to a corporation or government entity. A bond promises its owner a set amount of interest payments and full payment of the note's balance—typically $1,000 in the U.S.—on a specified date (the maturity date). These characteristics enable an investor to determine the amount and timing of cash flows he will receive. For a traditional bond, the issuer will pay a set amount of interest and, at maturity, will pay the par value of $1,000. Unless the issuer defaults, these are set amounts for traditional, non-callable bonds. This is why bonds are described as providing return of capital. Thanks to this characteristic, an investor can calculate his future return based on his purchase price and the prevailing yield, as long as he holds the bond to maturity.

A bond fund, whether it is a mutual fund, an exchange-traded fund (ETF) or a closed-end fund (CEF), is a managed portfolio of bonds. A fund's manager invests in a number of bonds meeting the criteria specified by the fund's objective. Should a bond mature, the fund manager will typically reinvest the proceeds in a new bond. Quite often, bonds are sold from the portfolio before maturity as the fund manager seeks to manage yield, duration (a bond's or a portfolio's sensitivity to interest rate changes), diversification and security selection.

More importantly, the typical bond fund is designed to last into perpetuity. In order to realize the return of their invested capital, shareholders must sell their shares at prevailing prices. Since the price of the shares fluctuates, there is no approximate dollar amount investors can plan on receiving in the future. The distributions paid by a bond fund also fluctuate depending on the composition of the portfolio and how the manager changes the holdings in response to shifting market conditions and interest rate expectations.

It is very possible to realize a loss of capital with a bond fund. If interest rates rise between the time an investor purchases and sells the bond fund, the fund's share price may drop in value, causing a loss for the investor. Potentially offsetting this decrease are the distributions paid by the fund, the change in the fund's yield, the portfolio decisions made by the fund manager and the length of time the investor holds the bond fund.

Bond funds hold a key advantage in terms of bond purchasing power. Though U.S. bonds have a par value of $1,000, they typically trade in far larger quantities. A round lot of municipal bonds is $100,000. An individual investor can find bonds trading in smaller lots, such as $5,000, but as the size of the transaction decreases in dollar amount, so do the choices of bonds available for purchase. It can also be more difficult to sell smaller lots of bonds than it is to sell larger lots. Anytime the pool of would-be buyers or sellers shrinks, the opportunity for mispricing increases.

Fund managers, conversely, have the ability to buy and sell large blocks of bonds. This gives them a greater selection of bonds and the ability to interact with a bigger range of buyers and sellers. Plus, since fund managers work with professional traders, they can get better pricing and lower transaction costs.

The Defined-Maturity Fund Solution

Defined-maturity funds seek to strike a middle ground between bonds and bond funds. Like bonds, these funds mature on a specified date and return the capital to shareholders. Like bond funds, they are professionally managed and benefit from the economies of scale that a large portfolio offers.

Defined-maturity funds mature during the year listed in their names. For example, the Fidelity Municipal Income 2015 Fund (FMLCX) will mature on June 30, 2015. Shortly after this date, the fund will return its proceeds to shareholders. This is an important distinction from most target date funds, which continue their existence after the year in their names are reached.

A big advantage of the termination dates is the ability to manage interest rate risk. An investor can build the equivalent of a bond ladder by investing in defined-maturity funds with different maturity dates. This allows him to stagger his exposure to changing interest rates instead of relying on forecasts that may or may not prove to be correct.

Defined-maturity funds are actual funds. Investors buy shares in a fund that holds a portfolio of bonds maturing around a specified date. Within the limitations specified in the objective, the fund manager has the ability to adjust the portfolio, including replacing funds. Bonds may also be added to or removed from the portfolio in reaction to purchases or redemptions from shareholders. This means investors are not buying into a static portfolio of bonds that are held until maturity but rather are purchasing a managed portfolio that evolves up until its maturity date.

Since these are actual funds, investors get the advantages of active management and effective buying power. The fund managers have access to the expertise of bond analysts and bond traders to assist with decisions regarding credit quality, valuation and bond selection. They also have access to a larger amount of data than the typical individual investor has and are better equipped to assess the attributes of bonds from municipalities or businesses an individual investor may not be familiar with. The traders a fund uses have a better understanding of the market and can get more favorable pricing. Plus, due to the sheer amount of dollars available to invest, a fund's portfolio is often more diversified than what most individual investors could create for themselves by buying bonds of similar maturities.

The disadvantage, of course, is that these are actively managed funds. Shareholders are reliant on the decisions of the fund manager and his team. If a fund manager makes poor bond choices or trades in a manner that creates taxable events, shareholders are adversely affected. Furthermore, the cumulative expenses paid by a shareholder may be more than the commissions paid for individual bonds.

Near the specified termination date, the fund will be liquidated and the proceeds will be distributed to shareholders, less any final expenses withheld from the balance. This amount may be more or less than what a particular shareholder paid for the shares. At termination, the fund will cease to exist. Investors wishing to access their investment dollars sooner can sell their shares in the fund prior to the expiration date.

The termination date of the fund will be listed in the prospectus. However, the maturity dates listed for these funds are not exact. And the maturity dates of the bonds held by these funds are not identical. Rather, the bonds held in these funds mature within a certain window of time leading up to the termination date of the fund.

As bonds mature in the final year of the fund, the proceeds may be invested in cash equivalent securities. As the transition to cash equivalent securities is made, the fund's yield will likely drop. This would particularly occur in the final months of a fund's intended life-span, with the intent of the fund's assets entirely consisting of cash by the termination date.

Fidelity, one of the three firms offering defined-maturity funds, maintains the right to close its defined-maturity funds to new shareholders. The company includes language in its prospectus to the effect that it also anticipates closing its defined-maturity funds to new purchases, both by prospective and current shareholders, during the 12-month period leading up to fund's maturity date. The defined-maturity funds offered by the other two firms, iShares and Guggenheim funds, are exchange-traded funds (ETFs), therefore, they never close to new investors. Shares in their funds are purchased on the open market instead of directly from the fund sponsor, as is the case with the Fidelity funds.

Tax Implications

If any of the funds are purchased in a taxable account, an investor may be liable for both income and capital gains taxes. Distributions from the Guggenheim and the iShares corporate bond defined-maturity ETFs are subject to federal taxes. The distributions from the Fidelity and the iShares municipal bond funds will be largely exempt from federal taxes though the prospectuses caution that some taxable income may also be distributed. (Since these funds are designed to be tax-friendly, any distribution of taxable income should be a small amount of overall income distributions.) These characteristics make the Fidelity and the iShares municipal bond funds more suitable for taxable accounts and the Guggenheim and the iShares corporate funds more suitable for traditional IRAs, Roth IRAs and similar accounts.

Capital gains distributions are a possibility from all defined-maturity funds. This would occur if a bond was sold at a profit in the portfolio. Short-term capital distributions, even from the municipal bond funds, would be taxed at ordinary income taxes. Long-term capital gains would qualify for the more favorable tax rate.

Capital gain tax liabilities could also be created if the fund shares are sold before the termination date or at the time when final proceeds are received. If long-term capital gains are realized by a fund and distributed to shareholders, the investor would have to pay taxes—as would be the case with distributions from another type of mutual fund or ETF (e.g., a stock fund). At the termination date, a shareholder could realize either a capital gain or capital loss depending on his purchase price. If shares were bought at a dollar amount higher than the redemption amount, an investor would be able to claim a capital loss for tax purposes. If the redemption amount is greater than the purchase price, the investor would have to pay capital gains taxes on the difference. (Investors holding the funds in a tax-advantaged account would not incur these tax issues.)

Individual bonds, in contrast, have different tax characteristics. When a bond is purchased at a premium price, the excess amount paid over par value can be amortized over the life-span of the bond. If the bond yields tax-exempt interest, the premium must be amortized. See IRS Publication 550 for more information on the tax treatment of individual bonds (www.irs.gov).

Another key difference is that an investor controls when bonds are added to or removed from his portfolio. This puts him in charge of determining the type and timing of capital gains taxes. He can also exert greater control over how any interest income is reinvested. This is an important distinction because even though the Fidelity and the iShares municipal bond funds are designed to be tax-friendly, they may not be as tax-friendly as a bond ladder created by an individual investor. This loss of tax control is a trade-off investors make for the advantages offered by defined-maturity funds.

Defined-maturity bond funds are an alternative to individual bonds, but not an exact substitute. While defined-maturity funds can serve a useful purpose in an individual investor's portfolio, both their advantages and disadvantages should be considered before purchase.

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