Should You Ever Buy a Bond Mutual Fund?

Description

There has been much discussion in recent years about the fees in equity mutual funds, and for good reason. With management expense ratios (MERs) over 2%, it has become very difficult for these funds to beat their respective benchmarks, and most of them don't.

Fixed income funds have lower fees, typically 1.0-1.5%. But with bond returns so low, the fees can be even more onerous than they are for equity funds. A comparison of bond funds provides an illustration.

A comparison

The following table shows the flagship Canadian bond fund for each of the big 5 banks.

Bank	Fund	Annual Fee	10-Year Annual Return
RBC	RBC Bond Fund	1.22%	4.4%
TD	TD Canadian Bond Fund	1.11%	4.52%
Bank of Nova Scotia	Scotia Canadian Income Fund	1.46%	4.01%
BMO	BMO Bond Fund	1.60%	3.63%
CIBC	CIBC Canadian Bond Fund	1.51%	4.4%
Average		**1.38%**	**4.19%**

Instead of buying one of these funds, an investor could have bought the **iShares Canadian Universe Bond Index ETF** (TSX: XBB), which currently charges 0.33% per year. Over 10 years, that investment would have returned 4.85% per year, beating every one of the bond funds in the table above. Why is this the case?

Tough to get an edge in bonds

When investing in stocks, there are always opportunities to gain an edge – prices can fluctuate wildly, creating opportunities for astute investors. So there tends to be a wide gap between the best stock pickers and everyone else.

But bonds are trickier. They require making economic predictions such as the movement of interest rates, and the reward for being right is relatively small (certainly compared to the reward for being right on a stock). The funds above are largely invested in safe assets like government of Canada debt, making it all the more difficult to outperform. And with interest rates so low, it's now even tougher to achieve high returns.

The fees are magnified

One can make a couple of interesting observations from the table above. One is that before factoring in fees, the bond funds made 5.57% per year over the past decade. This was actually higher than the bond ETF. So the fees were enough to turn outperformers into underperformers.

Secondly, the best-performing bond fund, which came from TD, also had the lowest fee. Meanwhile, the worst-performing fund, which came from Bank of Montreal, had the highest fee. Does anyone think this is just a coincidence?

Foolish bottom line

At the end of the day, when investing in safe assets like government of Canada bonds, you don't need to pay up for expertise. No matter who you are or what your goals are, you're better off in a bond ETF than a bond mutual fund.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)
6. TSX:XBB (iShares Core Canadian Universe Bond Index ETF)

Category

1. Investing

Date
2025/07/23
Date Created
2014/04/16
Author
bensinclair