INVESTMENT COMPANY INSTITUTE®

A GUIDE TO

Bond Mutual Funds

A **bond mutual fund** is an investment company that pools money from shareholders and invests primarily in a diversified portfolio of bonds.

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What Is a Bond?

A review of basic facts about bonds will be helpful in better understanding bond mutual funds. (All bold face terms are defined in the glossary at the end of the brochure.)

A **bond** is a type of security that functions like a loan. Bonds are IOUs issued by private companies, municipalities, or government agencies. The money used to purchase a bond is being lent to the **issuer**—that is, the company, municipality, or government agency that issued the bond. In exchange for the use of this money, the issuer promises to repay the amount loaned (the **principal**; also known as the **face value** of the bond) on a specific **maturity** date. In addition, the issuer typically promises to make periodic interest payments over the life of the loan.

After a bond is purchased, it may be traded. The price at which a bond trades, however, may differ from its face value. One reason bond prices fluctuate is due to changes to interest rates. Think of the relationship between bond prices and interest rates as opposite ends of a seesaw. When interest rates fall, a bond's value usually rises. When interest rates rise, a bond's value usually falls. Therefore, if a bond is sold before it matures, it may be worth more or less than the price paid for it.

Bonds are typically classified in three ways: by issuer, maturity, and quality.

Types of Issuers. The U.S. government sells bonds through the Treasury to finance the national debt and through various federal agencies for special purposes. State and local municipalities sell bonds to finance projects such as schools, hospitals, highways, bridges, and airports. Corporations sell bonds to finance long-term private projects, such as building new factories and offices or buying new equipment.

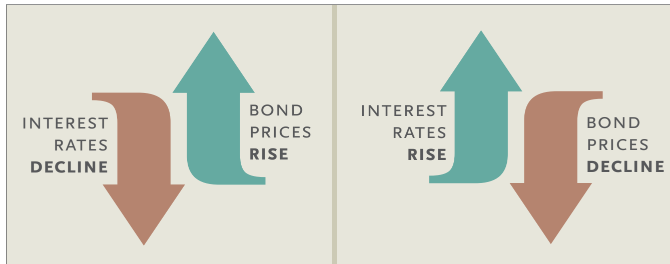
Maturity. Maturity refers to the length of the loan—the amount of time until the principal is due to be repaid. Short-term bonds generally mature in less than two years, although in many cases "short-term" may be interpreted to mean less than one year. Long-term bonds mature in more than 10 years. Intermediate-term bonds, as the name implies, mature between short- and long-term debt. In general, the longer a bond's maturity is, the greater its **interest rate risk** (see *Interest Rate Risk*, page 11).

Quality. Quality refers to the "creditworthiness" of the issuer, in other words, the likelihood that it will be able to make periodic interest payments and repay its debt. Independent rating services, such as Moody's Investors Service, Inc. or Standard & Poor's Corporation, publish directories (available in most large libraries and on the Internet) that rate bond quality. A lower rating means the service associates a greater **credit risk** with that particular bond issuer (see *Credit Risk*, page 12).

HOW DO CHANGING INTEREST RATES

Affect a Bond's Value?

Let's say a $10,000 bond paying 5 percent interest with a maturity of 30 years is bought today. Now suppose the buyer needs to sell the bond after only 10 years. At that time, the interest rate on new bonds is 7 percent. Why should investors purchase a bond paying only 5 percent when they can currently get 7 percent? In order to sell it, the owner selling the bond will need to drop the asking price of the bond below its $10,000 face value to approximately $7,900. This will, in effect, allow the new purchaser to earn the going market yield of 7 percent on the bond based upon the lower price.



The opposite is true when interest rates decline. A bond will then be paying more than what the current market offers, and the bond's owner could charge a premium price. The new purchaser receives less than he or she paid for the bond when it matures, making up for the higher-than-marketplace interest payments received in the interim.

What is a Bond Mutual Fund?

A bond mutual fund is an investment company created solely to manage a pool of investments—also called a **portfolio**—consisting primarily of individual bonds. (To a limited extent, bond mutual funds may also invest in other types of securities.) Investors purchase shares in the fund. Each share represents a proportional ownership interest in the pool of bonds comprising the fund's portfolio. Professional money managers use the money invested by **shareholders** to buy and sell bonds for the portfolio in accordance with the fund's investment objective. Because of the pooling of resources, bond mutual fund shareholders can invest in a greater variety of bonds than the average investor could individually. In addition, many bond mutual funds have minimum investments that are significantly less than the principal value of many individual bonds. For instance, a single Government National Mortgage Association (GNMA or Ginnie Mae) bond costs $25,000, but you can invest in most GNMA bond mutual funds with only $1,000.

TYPES OF BOND MUTUAL FUNDS

Type of Bond Mutual Fund	Typical Investment Objectives	Invests Primarily In	Principal Risks
Corporate	Income, Capital Preservation	Corporate Debt	Interest Rate, Some Credit
Global	Income, Capital Appreciation	U.S. and Non-U.S. Corporate and Government Debt	Currency, Political, Interest Rate, Some Credit
Ginnie Mae (GNMA)	Income, Capital Preservation	Mortgage Securities Backed by the Government National Mortgage Association	Prepayment, Interest Rate
High-Yield	Income, Capital Appreciation	Lower Quality Corporate Debt	Credit, Interest Rate
Income	Income, Capital Appreciation	Corporate and Government Debt	Interest Rate, Some Credit
National Municipal	Federal Tax-Exempt Income, Capital Preservation	State and Local Government Debt	Interest Rate, Some Credit
State Municipal	Federal and State Tax-Exempt Income, Capital Preservation	State and Local Government Debt of Only One State	Interest Rate, Some Credit
U.S. Government	Income, Capital Preservation	U.S. Treasury and Other Government Securities	Interest Rate

Who Owns Bond Mutual Funds?

Bond mutual funds have become an important way for U.S. households to invest in the bond market. Today, there are over 2,000 bond mutual funds for investors to choose from. Like most mutual fund shareholders, bond mutual fund investors usually own more than one type of mutual fund. In fact, 88 percent of all bond fund shareholders also own equity funds. Bond funds are particularly popular with retirees and older Americans because of the income and stability that bond fund investments provide.

BOND MUTUAL FUND ASSETS

(billions of dollars)

CHARACTERISTICS OF MUTUAL FUND OWNERS		
	All Mutual Fund Shareholders	Bond Fund Shareholders
Age *(median)*	48	48
Household Income *(median)*	$68,700	$77,000
Household Financial Assets *(median)*	$125,000	$185,000
Retired	21%	21%
Completed Four-Year Degree or More	56%	65%

Features of Bond Mutual Funds

Bond mutual funds have several important features that distinguish them from individual bonds. An individual bond has a maturity date. In addition, many bonds make fixed interest payments. However, a bond mutual fund, which is an actively managed portfolio of different bonds, does not have a maturity date, nor are its dividend payments fixed.

A bond mutual fund's **diversification** reduces exposure to risk. When a bond mutual fund owns a pool of bonds, the effect of one bond's value on the entire fund's share price is not nearly as great as it would be for an investor who held only a single bond.

Liquidity is another important feature of bond mutual funds. By law, a bond mutual fund must be ready to redeem (buy back) its shares on any business day at their current net asset value.

No Guarantees Available

There are no guarantees when investing in a bond mutual fund. Even if the individual bonds in the fund are guaranteed by the government or insured through a private insurer, the value of a bond mutual fund investment can still rise or fall. Bond mutual funds are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities Investor Protection Corporation (SIPC), or by any other government agency, regardless of how a bond mutual fund is purchased or sold—through a brokerage firm, a bank, an insurance agency, a financial planning firm, or directly. Nor are they guaranteed by the bank, brokerage firm, or other financial institution where they are sold.

Government Regulation

To protect investors, all mutual funds, including bond mutual funds, are highly regulated by the federal government through the **U.S. Securities and Exchange Commission (SEC)**. As part of this government regulation, all funds must meet certain operating standards, observe strict antifraud rules, and disclose complete information to potential investors. For example, funds must provide investors with a written **prospectus**. Read the prospectus carefully before investing. By law, a prospectus provides the following information:

- the fund's investment objective;
- a table of fees charged by the fund;
- the types of securities in which the fund invests and the investment methods used to achieve the fund's objective;
- the types of investment risks the fund is willing to assume in pursuit of its investment objective;
- the name and professional background of the fund's portfolio manager(s) and length of association with the fund (index funds and funds managed by committees are not subject to this requirement);

- how to purchase and redeem fund shares; and
- tax consequences of investing in the fund (tax-exempt funds explain which of your earnings will be exempt from federal tax).

Funds are also required to provide **annual and semiannual reports** to shareholders that describe the fund's pre-tax and **after-tax** performance during the period covered.

Risk Versus Reward

Bond mutual funds, like all mutual funds, involve investment risk, including the possible loss of principal. Nevertheless, when you make an informed decision to assume some risk, you also create the opportunity for reward. This is a fundamental principle of investing known as the **risk/reward tradeoff**. Investing in bond mutual funds usually entails less risk—and less reward—than investing in stock mutual funds. But the risk of loss and the potential for reward is greater in bond mutual funds than in investments such as money market funds or certificates of deposit. Money market funds attempt to maintain a constant share price (value), and bank deposit accounts are federally insured against loss up to certain levels. However, bond mutual funds are not insured, and their share prices, like bond prices themselves, fluctuate, creating both risk of loss and potential for greater reward.

There are several types of risk that could cause the value of bond mutual fund shares to decline. Three of these—interest rate risk, credit risk, and **prepayment risk**—are discussed below. Another inherent risk—**inflation risk**—is also discussed.

Interest Rate Risk

As discussed earlier, bond prices are closely related to interest rates. When interest rates go up, most bond prices go down. When interest rates go down, the bond prices go up.

The longer a bond's maturity, the more its price tends to fluctuate as market interest rates change. For example, a rise in interest rates will cause a larger drop in price for a 20-year bond than for an otherwise equivalent 10-year bond. However, while longer-term bonds tend to fluctuate in value more than shorter-term bonds, they also tend to have higher yields (see *Yield Versus Total Return*, page 16) to compensate for this risk.

A bond mutual fund, as previously mentioned, does not have a fixed maturity. It does, however, have an **average portfolio maturity**—the average of all the bonds' maturity dates in the fund's portfolio. In general, the longer a fund's average portfolio maturity, the more sensitive the fund's share price will be to changes in interest rates and the more the fund's shares will fluctuate in value. However, for the reason noted above, funds that invest in longer-term bonds will usually have higher yields.

Credit Risk

Credit risk refers to the creditworthiness of the bond issuer and its expected ability to pay interest and to repay its debt. If a bond issuer is unable to repay principal or interest on time, the bond is said to be in default. A decline in an issuer's credit rating, or creditworthiness, can cause bond mutual fund share prices to decline.

BOND CREDIT RATINGS

	Moody's Rating	Indicates:	Standard & Poor's Rating
Investment Grade	Aaa	Highest Quality	AAA
	Aa	High Quality	AA
	A	Good Quality	A
High-Yield or "Junk" Bonds	Baa	Medium Quality	BBB
	Ba	Speculative Quality	BB
	B	Speculative	B
	Caa	More Speculative	CCC
	Ca	Highly Speculative	CC
	—	In Default	D
	N	Not Rated	N

Note: Moody's and Standard & Poor's are only two of several agencies that rate bonds.

Prepayment Risk

Prepayment risk is the possibility that a bond owner will receive his or her principal investment back from the issuer prior to the bond's maturity date. This can happen when interest rates fall, giving the issuer an opportunity to borrow money at a lower interest rate than the one currently being paid. (For example, a homeowner who refinances a home mortgage to take advantage of decreasing interest rates has *prepaid* the mortgage.) As a consequence, the bond's owner will not receive any more interest payments from the investment. Prepayment also forces any reinvestment to be in a market where prevailing interest rates are lower than when the initial investment was made.

Prepayment risk is most prevalent in bond mutual funds that invest in mortgage-backed debt securities, such as Government National Mortgage Association (Ginnie Mae) funds. Mortgage-backed bond mutual funds typically pay a higher yield to compensate investors for the uncertainty associated with prepayment risk.

Inflation Risk

Choosing an investment solely for its stability entails inflation risk. Inflation erodes the purchasing power of any investment. For example, suppose $1,000 in a deposit account earns 5 percent interest, but inflation is 2 percent per year. Although this money will earn $50 in interest after one year, inflation cuts the actual worth of this $50 down to $49. In addition, the initial $1,000 will also erode by 2 percent to $980. Therefore, after one year, the deposit account has a balance of $1,050, but due to inflation, it is only worth $1,029. This is the effect of inflation risk. To maintain an investment's value, its total return (see *Yield Versus Total Return,* page 16) must keep pace with the inflation rate.

THE EFFECT OF INFLATION

In 2005, the inflation rate was 3.4 percent. Even at this historically low rate, inflation will erode the value of $1,000 by more than one-quarter in 15 years:

In this many years...	$1,000 will be worth...
5	$846
10	$716
15	$606
20	$512
25	$433
30	$367
35	$310
40	$263

assuming 3.4 percent annual inflation

Value of a Bond Mutual Fund

Like the value of an individual bond, the value of a bond mutual fund fluctuates. The current share price (known as **net asset value** or **NAV**) of a bond mutual fund is based on the actual value of the individual bonds and any other securities in the fund's portfolio, calculated daily. The NAV changes as the values of the bonds in the fund's portfolio change (for example, in response to changes in interest rates). The NAV also changes whenever the fund's manager alters its portfolio by selling some of its bonds or buying new ones.

In many cases, the fund managers will buy bonds after they are issued, or sell bonds before they mature. Since bond prices are constantly changing in response to changing interest rates, a bond mutual fund may experience gains or losses as bonds are traded, and these gains or losses are reflected in the bond mutual fund's NAV.

Share prices of a bond mutual fund can be found in daily newspapers or on websites. Many newspapers publish in their financial pages the net asset values of many bond mutual funds (along with other types of mutual funds) as of the close of the preceding business day. In some papers, the NAV is identified as the sell, or bid, price—the amount per share one would receive if shares were sold (less any deferred sales charges). On any given day, the value of an investor's holdings can be determined by multiplying the fund's NAV by the number of shares he or she owns. Also listed in the paper is the offering price, sometimes called the buy, or asked, price, which is the price paid to purchase shares. The offering price is the NAV plus any sales charges.

In general, when purchasing shares, the share price will be based on the NAV computed at the end of the business day on which the order is received.

If share prices have climbed since a purchase was made, the investor will benefit from those gains when shares are sold. Or, if share prices have dipped, the investor will absorb the loss. (The change in a bond mutual fund's NAV is not the sole measure of the fund's return. Dividends and other distributions to shareholders must also be taken into account—see below.)

Dividend distributions come primarily from the interest and dividends earned by the securities in the fund's portfolio after expenses. **Capital gain distributions** represent the fund's net gains, if any, from the sale of securities held in its portfolio for more than one year. When gains from these sales exceed losses, they are distributed to shareholders.

Yield Versus Total Return

Like money market funds, the interest earned on a bond mutual fund's portfolio is passed through to the investor as dividends. These dividends can be taken in cash or reinvested in the fund. This component of a bond mutual fund's earnings, less fund expenses, is called its **yield**.

What determines a bond mutual fund's yield? Two major factors affecting yield are the quality and maturity of the bonds in the fund's portfolio. In general, bonds with lower quality and longer maturities entail greater risk, and so must offer higher yields.

But as noted earlier, unlike CDs, the share price of a bond mutual fund can change. So to calculate **total return** from a bond mutual fund investment, one must include any change in the share price or NAV along with any income earned (dividends and capital gain distributions received). Yield alone—the amount of interest the fund is generating—is only part of the story. In fact, it may be possible for price **depreciation** to completely offset or even exceed income earned.

For More Information

For more information about bond mutual fund investments, contact your broker, financial planner, or mutual fund, or visit www.ici.org, the website of the Investment Company Institute, the national association of the investment company industry. Many mutual fund companies also provide educational materials on their own websites. A complete list of the Institute's member fund companies is available at www.ici.org/funds/mem/index.html.

Glossary of Terms

After-Tax Return—The total return of a fund after the effects of taxes on distributions and/or redemptions have been assessed. Funds are required by federal securities law to calculate after-tax returns using standardized formulas based upon the highest tax rates. (Consequently, they are not representative of the after-tax returns of most mutual fund shareholders.) These standardized after-tax returns are not relevant for shareholders in tax-deferred retirement accounts.

Annual and Semiannual Reports—Summaries that a mutual fund sends to its shareholders that discuss the fund's performance over a certain time period and identify the securities in the fund's portfolio on a specific date.

Appreciation—An increase in an investment's value.

Average Portfolio Maturity—The average maturity of all the bonds in a bond fund's portfolio.

Bond—A debt security, or IOU, issued by a company, municipality, or government agency. A bond investor lends money to the issuer and, in exchange, the issuer promises to repay the loan amount on a specified maturity date; the issuer usually pays the bondholder periodic interest payments over the life of the loan.

Capital Gain Distributions—Profits distributed to shareholders resulting from the sale of securities held in the fund's portfolio for more than one year.

Credit Risk—The possibility that a bond issuer may not be able to pay interest and repay its debt.

Depreciation—A decline in an investment's value.

Diversification—The practice of investing broadly across a number of securities to reduce risk, and a key benefit of investing in mutual funds and other investment companies.

Dividend Distributions—Distribution of a portion of a company's earnings, cash flow, or capital to shareholders in cash or additional stock. Mutual fund dividends are paid out of income, usually on a quarterly basis from the fund's investments.

Face Value—The amount that a bond's issuer must repay at the bond's maturity date.

Inflation Risk—The risk that all or part of an investment's return may be offset by inflation.

Interest Rate Risk—The possibility that a bond's or bond mutual fund's value will decrease due to rising interest rates.

Issuer—The company, municipality, or government agency that issues a security, such as a stock, bond, or money market security.

Liquidity—The ability to gain ready access to invested money. Mutual funds are liquid because their shares can be redeemed for current value (which may be more or less than the original cost) on any business day.

Maturity—The date by which an issuer promises to repay a bond's face value.

Net Asset Value (NAV)—The per-share value of a mutual fund, found by subtracting the fund's liabilities from its assets and dividing by the number of shares outstanding. Mutual funds calculate their NAVs at least once daily.

Portfolio—A collection of securities owned by an individual or an institution (such as a mutual fund) that may include stocks, bonds, money market instruments, and other securities.

Prepayment Risk—The possibility that a bond owner will receive his or her principal investment back from the issuer prior to the bond's maturity date.

Principal—See Face Value.

Prospectus—The official document that describes a mutual fund to prospective investors. The prospectus contains information required by the SEC, such as investment objectives and policies, risks, services, and fees.

Quality—The creditworthiness of the bond issuer, which indicates the likelihood that it will be able to repay its debt.

Risk/Reward Tradeoff—The principle that an investment must offer higher potential returns as compensation for the likelihood of increased volatility.

Shareholder—An investor who owns shares of a mutual fund or other company.

Total Return—A measure of a fund's performance that encompasses all elements of return: dividends, capital gain distributions, and changes in net asset value. Total return is the change in value of an investment over a given period, assuming reinvestment of any dividends and capital gain distributions, expressed as a percentage of the initial investment.

U.S. Securities and Exchange Commission (SEC)—The primary U.S. government agency responsible for the regulation of the operations and disclosure obligations of mutual funds (among other investments).

Yield—A measure of net income (dividends and interest) earned by the securities in the fund's portfolio less the fund's expenses during a specified period. A fund's yield is expressed as a percentage of the maximum offering price per share on a specified date.

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