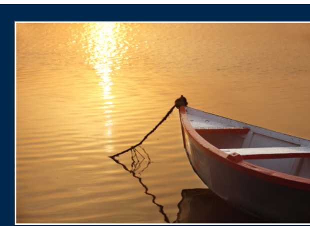

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# Attributes of Investing in Individual Bonds vs. a Bond Fund

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Should an investor hold individual bonds or invest in a bond fund? Some make the case for investing in individual bonds in a rising rate environment because investors, if they hold the bond until maturity, may receive their principal back with possibly little risk of suffering losses in market value if prices fluctuate. If you hold a bond until it matures, you may receive 100% of your investment back (without a default or factoring in inflation). Bond funds, which don't have a fixed maturity date, may fall in price if interest rates rise. But individual bonds also fluctuate in value when rates rise; many investors are just unaware because they aren't pricing it daily. Individuals bonds sold before maturity could drop in price similarly to a bond fund in a rising rate situation. Thinking that individual bonds are safer than bond funds may not necessarily be the case.

## The Impact of "Cash Drag"

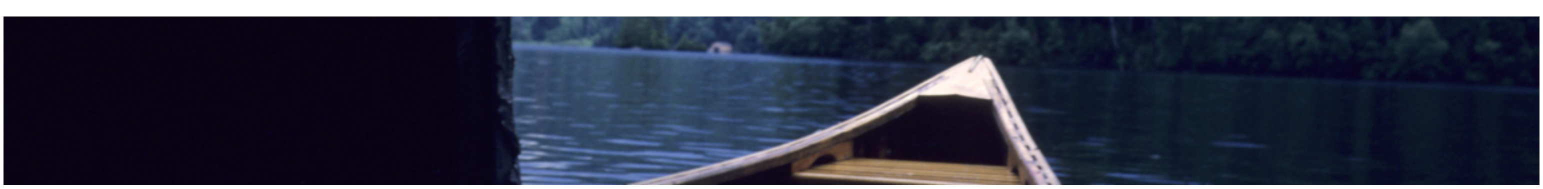
Individual bonds do have one disadvantage over bond funds. They are subject to what industry experts call "cash drag"— the effect of your portfolio not being fully invested. In this case, cash drag would occur when individual bond income falling below minimum purchase requirements is invested into a comparatively low yielding bank account whereas bond fund income may be reinvested in the fund. Also, if interest rates rise, investors may reinvest in higher yielding bonds and buy more shares in the fund. Given the power of compound interest, a bond fund with an average yield of 4% may generate greater total income over time than an individual bond with a 4% coupon.

| Individual Bond | Bond Fund |
|---|---|
| $20,000 corporate bond paying 4% in semi-annual payments | $20,000 invested in a corporate bond fund with a 4% yield |
| $400 dollars interest income generated every six months | Income reinvested in the fund |
| Cannot purchase bonds with income proceeds due to minimums – invest at bank account rates | If interest rates rise, reinvest income in new bond holdings in the fund at higher rates and buy more shares in the fund |

*For Illustrative Purposes Only*

## Other Potential Advantages of Bond Funds

Bond funds offer some other advantages over individual bonds. Funds offer diversification. They hold many securities and trade them cost-effectively offering lower trading costs than an investor may realize on their own. On the backside of this piece is a quick chart comparing features of individual bonds vs. bonds funds.



**Elements to Compare: Bonds vs. Bond Funds**

**Investment Assessment**

| | **Investment Management** | **Investment Research** | **Expenses** |
|---|---|---|---|
| **Individual Bonds** | Investor managed | Investor | A markup or spread is taken at the time of purchase |
| **Bond Funds** | Professionally managed | Portfolio managers and analysts | Expense ratio includes a management fee; may have a sales charge, transaction fee or redemption fee |

**Income & Maturity**

| | **Income** | **Maturity Date** |
|---|---|---|
| **Individual Bonds** | Fixed amount at pre-determined frequency | Set dates |
| **Bond Funds** | Fluctuating amount with various frequency options among available mutual funds | No stated maturity date for a bond fund, though bond holdings in the fund mature on varying dates and the portfolio manager must reinvest at then current yields |

**Risk Assessment**

| | **Market Risk** | **Liquidity Risk** | **Credit Risk** | **Diversification Risk** |
|---|---|---|---|---|
| **Individual Bonds** | A capital gain or loss may result in selling a bond prior to maturity. Bond holders may not notice fluctuation in their bond price if bonds are bought and held to maturity | May sell prior to maturity at the current price which may be more or less than par. Individual bonds vary in their liquidity; a lack of liquidity may result in price volatility | Higher rated bonds may have a lower risk of default | In order to diversify, an investor needs to purchase a number of individual bonds which may require a large investment amount |
| **Bond Funds** | A fund's net asset value will reflect fluctuations due to market risks; redeeming shares may result in a capital gain or loss | Fund shares may be sold at any time at the current net asset value of the fund, subject to individual fund restrictions, fees, charges and expenses related to the size of the redemption | A fund with some level of diversification may reduce credit risk. Credit risk may vary by fund type, holdings and objectives | Bond funds invest in many individual securities providing diversification for a lower minimal investment amount |

**Further Potential Bond Fund Advantage: Unconstrained Approach**

Bond funds appear to offer some advantages over individual bonds including diversification and compound income. All the while, there are a variety of bond funds to choose from using various bond sectors to varying degrees. While the long list of bond funds to consider for use may appear daunting, understanding the differing nature of bond sectors may be an important part of a bond investment strategy.

In our experience, when there are perceived risks in one bond asset class, there is often opportunity in another. Moving between different bond classes at the appropriate time may help manage risk in a bond portfolio. Additionally, having the ability to move completely into cash may also be an advantage for a bond fund.

We believe today's environment calls for an unconstrained approach to bonds with the ability to move between bond asset classes and even into cash based on economic indicators and market opportunities. Going forward, the potential variance in results among bond asset classes may be more pronounced than we have seen in the past 30 years. In our view, this creates opportunity for a more tactical approach. Now may be the time for an unconstrained approach and to find opportunity in the bond market.



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