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Forget skill; fees drive bond fund returns

By David Hoffman
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PHILADELPHIA — It is a message he has delivered many times before, but industry experts said John C. Bogle's continued assertion that bond funds on average are too expensive deserves special attention in the current market.

The reason is that bond fund returns are expected to remain low, they said.

That is a problem for most bond funds, because there already is very little that differentiates top-decile performers from those at the bottom, except price, said Paul Herbert, a senior fund analyst with Morningstar Inc. of Chicago.

And in a low-return environment, price becomes even more important, he said.

It is the nature of the market, Mr. Bogle, the founder and former chairman of The Vanguard Group Inc. of Malvern, Pa., said this month at a meeting sponsored by the Fixed Income Analysts Society Inc. of New York.

Speaking specifically about municipal bond funds, he said: "Remarkably small return is attributable to skill in bond funds." But that is true not just for municipal bond funds, he said in a follow-up interview. Price, not skill, is the driving force behind returns in all styles of bond funds, Mr. Bogle said.

It's what gives the $5.37 billion Vanguard Intermediate-Term Investment Grade Bond Fund, and the $6.3 billion Vanguard Intermediate-Term Bond Index Fund, an edge over the competition, he said.

The funds' Investor class of shares have expense ratios of 0.21% and 0.18%, respectively, and the Admiral class of shares have expense ratios of 0.10% and 0.11%. The average expense ratio for the intermediate-term, investment-grade-bond-fund category was 0.93%.

The result, Mr. Bogle said, is better performance for the two Vanguard funds.

The Investor class Vanguard Intermediate-Term Investment Grade Bond Fund had returned 2.16% year-to-date through last Monday, placing it in the 12th percentile of its category; it had a one-year return of 8.11%, placing it in the ninth percentile; a three-year annualized return of 4.4%, placing it in the 20th percentile; and a five-year return of 5.76%, placing it in the 10th percentile.

The Investor class Vanguard Intermediate-Term Bond Index Fund had a year-to-date return from the same period of 1.93%, placing it in the 32nd percentile of its category; a one-year return of 7.87%, placing it in the 12th percentile; a three-year annualized return of 4.18%, placing it in the 31st percentile; and a five-year return of 5.60%, placing it in the 13th percentile.

Not everyone, however, was willing to chalk up good bond fund performance to price alone.

There are bond funds that can provide “extra return” for shareholders through skill, said Jeff Feldman, president of Rochester Financial Services in Pittsford, N.Y.

He singled out the $102.96 billion Pimco Total Return Fund, advised by Pacific Investment Management Co. LLC in Newport Beach, Calif.

Sweet returns

The Institutional class of shares of the intermediate-term-bond fund had an expense ratio higher than that of the two Vanguard funds (0.44%), but it has generated good long-term returns under the leadership of fund manager William H. Gross.

It had a year-to-date return of 1.83%, placing it in the 45th percentile of its category; a one-year return of 6.47%, placing it in the 60th percentile; a three-year annualized return of 4.45%, placing it in the 19th percentile; and a five-year annualized return of 5.37%, placing it in the 19th percentile.

Of course, not everyone invests in Pimco Total Return fund via Institutional shares.

Class A shares of the fund have an expense ratio of 0.90% and come with a 3.57% maximum sales charge.

Bond fund investors don’t seem to mind paying such loads.

Only about 38% of all bond fund assets are in no-load funds, Mr. Bogle said.

But given that the low-return environment is expected to continue for bonds, investors should be concerned about paying loads, he said. It adds to the overall costs, Mr. Bogle said.

Morningstar is neutral when it comes to loads, but Mr. Herbert said he was “a little surprised” more bond fund investors weren’t in no-load funds.