November 2023

Cherry Tree Wealth Management

CHERRY TREE WEALTH INSIGHTS: Published by Keith Tufte, President of Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.

TARGET DATE BOND FUNDS– LOCKING IN CURRENT HIGH BOND YIELDS

Interest rates have increased dramatically over the past several years. This makes bonds much more attractive than they were a few years ago. The expected returns from bonds going forward are much better than they have been in 15+ years due to the current high interest rates. The majority of the bond funds we own have current yields of an attractive 5.0%-6.0% per year. Two years ago most bond yields were 2% or less.

We think it is smart at this point to start "locking in" these nice high interest rates for a longer period of time so we can benefit from them for many years. There are two ways to do this:

1. Extend the average maturity of your bond portfolio by trimming short-term bond funds and adding to longer-term bond funds. We have been doing this in our client portfolios over the past six months.
2. Adding some target date bond funds to your bond portfolio.

What are target bond funds? These are bond funds that own hundreds of bonds that all mature in a certain year, such as 2026. If you buy and hold these funds until they mature (2026 in this example), you will get the stated yield to maturity on the fund over that 3-year time period. It is like holding an individual bond until it matures, in that you know ahead of time what the actual yield/return will be. The current yield on these target date corporate bond funds is a nice 5.8% per year. You can create a bond ladder with these target date bond funds if you wish, buying some of the 2025, 2026, 2027, etc. bond funds. They offer some of the advantages of an individual bond ladder or owning CDs (a known return ahead of time), without many of the disadvantages of those investment strategies.

WHAT ARE THE POSITIVES OF OWNING SOME OF THESE TARGET DATE BOND FUNDS?

1. You can lock in the current high yield of 5.8% over the coming many years. This 5.8% yield is for the corporate bond target date funds. The US Treasury target date bond funds have a somewhat lower yield of 4.6%-4.8%.
2. They add some certainty to your bond returns (reduces the volatility due to interest rate movements). If you hold these bond funds to maturity, you know that you will get very close to 5.8% per year over that time period.
3. These are low-cost (expense ratio of only 0.10% per year), large, diversified, liquid funds.
4. They are better (and less risky) than an individual bond ladder because they are MUCH more diversified. They own many hundreds of bonds in each fund vs. only 5-10 individual bonds in a bond ladder.
5. They are better than buying CDs because the yields are higher, the term is much longer, the tax rate may be lower, they are liquid, and they are more diversified and easier to manage than CDs.
6. It is likely that some of the return from owning these bond funds will be taxed at the lower capital gains tax rate, since nearly all the bonds they own now are trading at a discount to face value.

Comparison of a traditional corporate bond fund to a target date corporate bond fund.

Traditional Bond Fund. Vanguard Short-Term Corporate Bond Fund (VCSH). The expected return (current yield to maturity) is 5.8%. Your actual realized return will depend on the change in overall interest rates over the coming year(s). If interest rates increase by 1% over the coming year your actual return will be about 3.3%. If interest rates are flat your actual return will be 5.8%, the same as the expected return. If interest rates decline by 1% your actual return will be about 8.5%.

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Target Date Bond Fund. IShares Target Date 2025 Corporate Bond Fund (IBDQ). The expected return (current yield to maturity) is also 5.8%. If you hold this fund to maturity (2025) your actual return is certain to be very close to the expected return of 5.8% per year. Many investors would like this certainty of 5.8% return (rather than a range of likely returns) with some of their bond portfolio.

Other things to be aware of related to target date bond funds:

1. The expected pretax return of these funds is the same as the traditional corporate bond funds (not higher). The primary advantage is adding some certainty (less variability) to your expected future bond returns over a multi-year time period.

2. These target date bonds will still go up and down in the interim (between now and when they mature) due to changes in interest rates just like other bond funds. In the first year they will be just as volatile as other bond funds with the same average duration/maturity. They will be less volatile as we get closer to the maturity year for that target date bond fund.

3. These target date bond funds may be attractive for investors that have a certain known liability (buying a second home, paying for college, etc.) coming up in several years. We can match that known year-specific liability with the target date bond fund of the same year.

4. Clients who have been conservative and have a large pile of money invested in money market funds may find these target date bond funds of interest, as they offer higher yields than money market funds and they lock the nice high yields in for many years compared to only days or weeks for a money market fund.

"These target date bond funds add some certainty to your future bond returns... we think it is smart to start locking in these nice high-bond yields"

How do we add these funds to a typical client's bond portfolio? For those clients who are interested, we can replace some (likely not all) of their existing corporate bond funds with these target date corporate bond funds. We would leave the other types of bond funds (floating rate bond funds, inflation-protected bond funds, Muni bond funds, government bond funds, etc.) as is. Some clients also may wish to add some of the US Treasury Bond target date funds, which are more secure in terms of credit quality but offer lower yields (4.7% per year).

We think these target date bond funds are an interesting option for certain investors as a part of their overall bond portfolio. We would be happy to discuss target date bond funds with you to see if they are a good fit for your portfolio, and if so the best way to add them.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (President of CTW) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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