

Defined-Maturity Funds: A Bond Alternative With Compromises

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Article Highlights

- Defined-maturity funds are managed portfolios of bonds that terminate near preset dates.
- These funds can offer greater diversification than individual bonds and can be laddered to reduce interest rate risk.
- Some tax events may be triggered even when investing in defined-maturity funds that hold municipal bonds.

Defined-maturity funds are hybrid funds designed to bridge one of the biggest gaps between traditional bond funds and individual funds.

As the name implies, defined-maturity bonds cease their existence on a specified date. At maturity, investors receive a distribution equivalent to the fund's net asset value. These funds are intended to be a solution for investors who desire certainty over the timing of cash flows or wish to stagger their interest rate exposure, but do not want to invest in individual bonds. Since these are funds, however, they come with compromises that should be understood and considered before purchase.

The complexities lie not only in the structure of the funds themselves, but also in the differences between bonds and bond funds. Understanding how these two differ helps to better understand the role defined-maturity funds can play in a portfolio.

In this article, I discuss the differences between individual bonds and defined-maturity funds. I then compare and contrast the offerings from the only three firms I was able to identify as currently offering defined-maturity funds: Fidelity, Guggenheim and iShares. I also include real-world examples of monthly and final distributions (sidebar boxes).



in the key differences between bonds and bond funds: maturity versus perpetuity. Bonds cease to exist at maturity while bond funds are designed to last into perpetuity. The difference affects the return of capital an investor can expect at the time he makes an investment.

Bond Maturity

A bond is essentially a loan to a corporation or government entity.

A bond promises its owner a set amount of interest payments and full payment of the note's balance—typically \$1,000 in the U.S.—on a specified date (the maturity date). These characteristics enable an investor to determine the amount and timing of cash flows he will receive. For a traditional bond, the issuer will pay a set amount of interest and, at maturity, will pay the par value of \$1,000. Unless the issuer defaults, these are set amounts for traditional, non-callable bonds. This is why bonds are described as providing return of capital. Thanks to this characteristic, an investor can calculate his future return based on his purchase price and the prevailing yield, as long as he holds the bond to maturity.

A bond fund, whether it is a mutual fund, an exchange-traded fund (ETF) or a closed-end fund (CEF), is a managed portfolio of bonds. A fund's manager invests in a number of bonds meeting the criteria specified by the fund's objective. Should a bond mature, the fund manager will typically reinvest the proceeds in a new bond. Quite often, bonds are sold from the portfolio before maturity as the fund manager seeks to manage yield, duration (a bond's or a portfolio's sensitivity to interest rate changes), diversification and security selection.

Bonds Versus Bond Funds

The underlying premise for defined-maturity bonds lies

Variance in Monthly Distributions

Due to the short history of defined-maturity bond funds, there is not a large amount of data showing how stable or variable the monthly distributions are. iShares' first defined-maturity ETF, the iShares 2012 S&P AMT-Free Municipal Term ETF (MUAA) does provide an example, however.

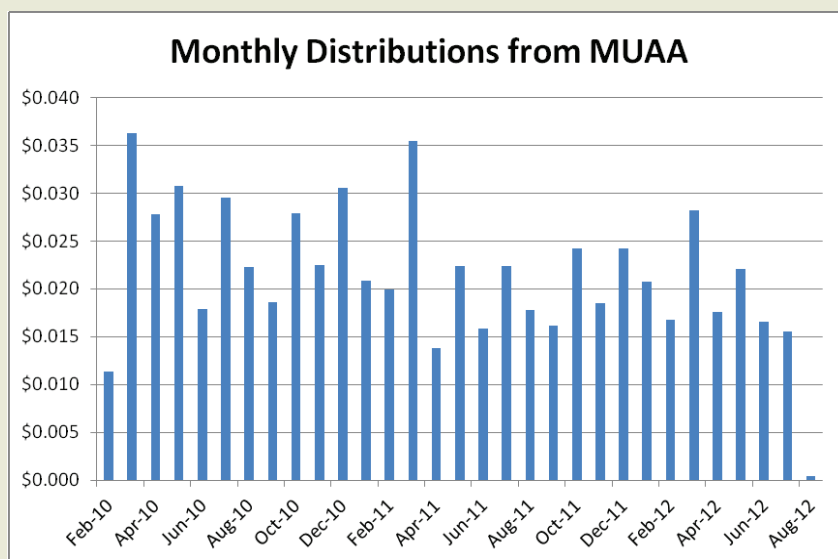
The fund was launched on January 8, 2010, and the first distribution was made on February 10, 2010. The

fund terminated in August 2012. Monthly distributions for the exchange-traded fund ranged from \$0.000 to \$0.036 per month. (The August 2012 distribution was \$0.00046 per share.) The table below, which is based on data from iShares, shows the variance in monthly distributions.

At the fund's termination, investors received a final distribution of \$50.62 per share, which was above the fund's initial net asset value of \$50.38. This amount was left off the chart to better show the changes in the monthly distributions.

Any variance in monthly distributions will depend on several factors, including how a fund is managed and whether or not changes are made in its portfolio. Thus, while this table gives a real-world example of what happened with one specific fund, the variance from other defined-maturity funds, including those offered by iShares, may differ.

Investors preferring more stability in the cash payouts may want to consider an actual bond ladder instead. A ladder of individual bonds will provide an investor with a steady stream of income payments as long as the bonds have not matured, no defaults occur or no reinvestments are made.



More importantly, the typical bond fund is designed to last into perpetuity. In order to realize the return of their invested capital, shareholders must sell their shares at prevailing prices. Since the price of the shares fluctuates, there is no approximate dollar amount investors can plan on receiving in the future. The distributions paid by a bond fund also fluctuate depending on the composition of the portfolio and how the manager changes the holdings in response to shifting market conditions and interest rate expectations.

It is very possible to realize a loss of capital with a bond fund. If interest rates rise between the time an investor purchases and sells the bond fund, the fund's share price may drop in value, causing a loss for the investor. Potentially offsetting this decrease are the distributions paid by the fund, the change in the

fund's yield, the portfolio decisions made by the fund manager and the length of time the investor holds the bond fund.

Bond Liquidity

Bond funds hold a key advantage in terms of bond purchasing power. Though U.S. bonds have a par value of \$1,000, they typically trade in far larger quantities. A round lot of municipal bonds is \$100,000. An individual investor can find bonds trading in smaller lots, such as \$5,000, but as the size of the transaction decreases in dollar amount, so do the choices of bonds available for purchase. It can also be more difficult to sell smaller lots of bonds than it is to sell larger lots. Anytime the pool of would-be buyers or sellers shrinks, the opportunity for mispricing increases.

Fund managers, conversely, have the ability to buy and sell large blocks of

bonds. This gives them a greater selection of bonds and the ability to interact with a bigger range of buyers and sellers. Plus, since fund managers work with professional traders, they can get better pricing and lower transaction costs.

The Defined-Maturity Fund Solution

Defined-maturity funds seek to strike a middle ground between bonds and bond funds. Like bonds, these funds mature on a specified date and return the capital to shareholders. Like bond funds, they are professionally managed and benefit from the economies of scale that a large portfolio offers.

Defined-maturity funds mature during the year listed in their names. For example, the Fidelity Municipal Income 2015 Fund (FMLCX) will mature on

June 30, 2015. Shortly after this date the fund will return its proceeds to shareholders. This is an important distinction from most target date funds, which continue their existence after the year in their names are reached. (For more information about target date funds, see “Target Date Funds: A Simple Premise, but Underlying Complexities” in the October 2012 *AAII Journal*.)

A big advantage of the termination dates is the ability to manage interest rate risk. An investor can build the equivalent of a bond ladder by investing in defined-maturity funds with different maturity dates. This allows him to stagger his exposure to changing interest rates instead of relying on forecasts that may or may not prove to be correct.

Defined-maturity funds are actual funds. Investors buy shares in a fund that holds a portfolio of bonds maturing around a specified date. Within the limitations specified in the objective, the fund manager has the ability to adjust the portfolio, including replacing funds. Bonds may also be added to or removed from the portfolio in reaction to purchases or redemptions from shareholders. This means investors are not buying into a static portfolio of bonds that are held until maturity but rather are purchasing a managed portfolio that evolves up until its maturity date.

Since these are actual funds, investors get the advantages of active management and effective buying power. The fund managers have access to the expertise of bond analysts and bond traders to assist with decisions regarding credit quality, valuation and bond selection. They also have access to a larger amount of data than the typical individual investor has and are better equipped to assess the attributes of bonds from municipalities or businesses an individual investor may not be familiar with. The traders a fund uses have a better understanding of the market and can get more favorable pricing. Plus, due to the sheer amount of dollars available to invest, a fund's portfolio is often more diversified than what most individual investors could create for themselves by buying bonds of similar maturities.

The disadvantage, of course, is that these are actively managed funds. Shareholders are reliant on the decisions of the fund manager and his team. If a fund manager makes poor bond choices or trades in a manner that creates taxable events, shareholders are adversely affected. Furthermore, the cumulative expenses paid by a shareholder may be more than the commissions paid for individual bonds.

How Defined-Maturity Bond Funds Work

Defined-maturity bond funds hold a portfolio of bonds set to mature near the fund's expiration date. The bonds held by the fund can be replaced in the years leading up to the maturity date at the manager's discretion. Such trades could occur if a bond is called, the credit outlook changes, inflows or outflows from the fund alter the cash balance or other similar reasons. As such, it is possible for these types of funds to generate capital gains or losses for shareholders holding them in a taxable account.

Near the specified termination date, the fund will be liquidated and the proceeds will be distributed to shareholders. At that time, the fund will cease to exist. Investors wishing to access their investment dollars sooner can sell their shares in the fund prior to the expiration date.

The termination date of the fund will be listed in the prospectus. The Guggenheim BulletShares 2014 Corporate Bond ETF (BSCE) “will terminate on or about December 31, 2014.” Notice the terminology used. The maturity dates listed for these funds are not exact. And the maturity dates of the bonds held by these funds are not identical. Rather, the bonds held in these funds mature within a certain window of time leading up to the termination date of the fund.

As bonds mature in the final year of the fund, the proceeds may be invested in cash equivalent securities. Guggenheim's funds have the option of holding U.S. Treasury bills and investment-grade commercial paper. Fidelity's funds may hold money market securities. The iShares funds may hold money market

funds affiliated with BlackRock Fund Advisors, AMT-free tax-exempt municipal notes, variable rate demand notes and obligations, tender option bonds and municipal commercial paper. As the transition to these cash equivalent securities is made, the fund's yield will likely drop. This would particularly occur in the final months of a fund's intended life-span, with the intent of the fund's assets entirely consisting of cash by the termination date.

At termination, the fund's balance is distributed to shareholders, less any final expenses withheld from the balance. This amount may be more or less than what a particular shareholder paid for the shares.

Fidelity maintains the right to close its defined-maturity funds to new shareholders. The company includes language in its prospectus to the effect that it also anticipates closing its defined-maturity funds to new purchases, both by prospective and current shareholders, during the 12-month period leading up to fund's maturity date. Because iShares and Guggenheim funds are ETFs, they never close to new investors. Shares in their funds are purchased on the open market instead of directly from the fund sponsor, as is the case with the Fidelity funds.

Tax Issues

If any of the funds are purchased in a taxable account, an investor may be liable for both income and capital gains taxes. Distributions from the Guggenheim and the iShares corporate bond defined-maturity ETFs are subject to federal taxes. The distributions from the Fidelity and the iShares municipal bond funds will be largely exempt from federal taxes, though the prospectuses caution that some taxable income may also be distributed. (Since these funds are designed to be tax-friendly, any distribution of taxable income should be a small amount of overall income distributions.) These characteristics make the Fidelity and the iShares municipal bond funds more suitable for taxable accounts and the Guggenheim and the

Table 1. Current Defined-Maturity Funds

Fund Name (Ticker)	SEC Yield (%)	Expense Ratio (%)
Fidelity (www.fidelity.com, 800-343-3548)		
Fidelity Municipal Income 2015 Fund (FMLCX)	0.51	0.40
Fidelity Municipal Income 2017 Fund (FMIFX)	1.24	0.40
Fidelity Municipal Income 2019 Fund (FMCFX)	2.16	0.40
Fidelity Municipal Income 2021 Fund (FOCFX)	1.94	0.40
Fidelity Municipal Income 2023 Fund (FCHPX)	3.03	0.40
Guggenheim (www.guggenheiminvestments.com, 800-820-0888)		
Guggenheim BulletShares 2013 Corp Bond ETF (BSCD)	0.39	0.24
Guggenheim BulletShares 2014 Corp Bond ETF (BSCE)	0.56	0.24
Guggenheim BulletShares 2015 Corp Bond ETF (BSCF)	0.85	0.24
Guggenheim BulletShares 2016 Corp Bond ETF (BSCG)	1.27	0.24
Guggenheim BulletShares 2017 Corp Bond ETF (BSCH)	1.94	0.24
Guggenheim BulletShares 2018 Corp Bond ETF (BSCI)	2.29	0.24
Guggenheim BulletShares 2019 Corp Bond ETF (BSCJ)	2.82	0.24
Guggenheim BulletShares 2020 Corp Bond ETF (BSCK)	3.31	0.24
Guggenheim BulletShares 2021 Corp Bond ETF (BSCL)	3.57	0.24
Guggenheim BulletShares 2022 Corp Bond ETF (BSCM)	3.83	0.24
Guggenheim BulletShares 2013 Hi Yld Corp Bd ETF (BSJD)	3.00	0.42
Guggenheim BulletShares 2014 Hi Yld Corp Bd ETF (BSJE)	5.06	0.42
Guggenheim BulletShares 2015 Hi Yld Corp Bd ETF (BSJF)	4.97	0.42
Guggenheim BulletShares 2016 Hi Yld Corp Bd ETF (BSJG)	4.87	0.42
Guggenheim BulletShares 2017 Hi Yld Corp Bd ETF (BSJH)	4.91	0.42
Guggenheim BulletShares 2018 Hi Yld Corp Bd ETF (BSJI)	5.61	0.42
iShares (www.ishares.com, 800-474-2737)		
iShares 2014 AMT-Free Muni Term ETF (MUAC)	(0.01)	0.30
iShares 2015 AMT-Free Muni Term ETF (MUAD)	0.25	0.30
iShares 2016 AMT-Free Muni Term ETF (MUAE)	0.61	0.30
iShares 2017 AMT-Free Muni Term ETF (MUAF)	1.06	0.30
iShares 2018 AMT-Free Muni Term ETF (MUAG)	1.30	0.30
iSharesBond 2016 Corporate Term ETF (IBDA)	0.83	0.10
iSharesBond 2018 Corporate Term ETF (IBDB)	1.60	0.10
iSharesBond 2020 Corporate Term ETF (IBDC)	2.35	0.10
iSharesBond 2023 Corporate Term ETF (IBDD)	2.78	0.10
iSharesBond 2016 Corp ex-Financials Term ETF (IBCB)	0.83	0.10
iSharesBond 2018 Corp ex-Financials Term ETF (IBCC)	1.75	0.10
iSharesBond 2020 Corp ex-Financials Term ETF (IBCD)	2.82	0.10
iSharesBond 2023 Corp ex-Financials Term ETF (IBCE)	3.65	0.10

Source: Morningstar, Inc. Data as of 8/31/2013.

iShares corporate funds more suitable for traditional IRAs, Roth IRAs and similar accounts.

Capital gains distributions are a possibility from all defined-maturity funds. This would occur if a bond was sold at a profit in the portfolio. Short-term capital distributions, even from the municipal bond funds, would be taxed

at ordinary income taxes. Long-term capital gains would qualify for the more favorable tax rate.

Capital gain tax liabilities could also be created if the fund shares are sold before the termination date or at the time when final proceeds are received. If long-term capital gains are realized by a fund and distributed to shareholders,

the investor would have to pay taxes—as would be the case with distributions from another type of mutual fund or ETF (e.g., a stock fund). At the termination date, a shareholder could realize either a capital gain or capital loss depending on his purchase price. If shares were bought at a dollar amount higher than the redemption amount, an investor would be able to claim a capital loss for tax purposes. If the redemption amount is greater than the purchase price, the investor would have to pay capital gains taxes on the difference. (Investors holding the funds in a tax-advantaged account would not incur these tax issues.)

Individual bonds, in contrast, have different tax characteristics. When a bond is purchased at a premium price, the excess amount paid over par value can be amortized over the life-span of the bond. If the bond yields tax-exempt interest, the premium must be amortized. See IRS Publication 550 for more information on the tax treatment of individual bonds (www.irs.gov).

Another key difference is that an investor controls when bonds are added to or removed from his portfolio. This puts him in charge of determining the type and timing of capital gains taxes. He can also exert greater control over how any interest income is reinvested. This is an important distinction because even though the Fidelity and the iShares municipal bond funds are designed to be tax-friendly, they may not be as tax-friendly as a bond ladder created by an individual investor. This loss of tax control is a trade-off investors make for the advantages offered by defined-maturity funds.

Characteristics of the Funds

Table 1 shows a listing of the defined-maturity funds available as of September 10, 2013. As the funds with the nearest maturity dates terminate, it is expected that new, longer-dated funds will be introduced. Check each fund families' website for the most current list.

Fidelity

Fidelity is unique in that its fixed-

maturity offerings are mutual funds. The funds can be purchased directly from Fidelity or through other investment firms including some discount brokerage firms. (Morningstar lists Scottrade, TD Ameritrade and Vanguard among the brokers offering Fidelity defined-maturity funds.) Since these are mutual funds, shares are bought and sold at net asset value at the end of each day. A minimum initial investment of \$10,000 per fund is required. The funds may be closed to purchases during the 12-month period leading up to termination. The expense ratio for all five funds is 0.40%. Distributions are made monthly.

Five defined-maturity funds are offered, with maturity dates ranging from 2015 through 2023. The funds are spaced at two-year intervals. The targeted termination date for all of the funds is June 30 of the year listed in the fund's name. In the final year of each fund, the proceeds from maturing bonds may be invested in municipal money market securities.

All five funds primarily invest in investment-grade municipal bonds. Income from these bonds is expected to be exempt from federal taxes, though tax rules vary by state. The funds' manager Mark Sommer told me that he selects bonds with maturity dates matching each fund's termination date. In other words, the Fidelity Municipal Income 2015 Fund (FMLCX) holds bonds maturing at or mostly prior to June 30, 2015. He tries to avoid callable bonds, though he does consider them for the longer-dated funds when there aren't enough non-callable bonds to select from.

Sommer's intent is to hold bonds until maturity. He may, however, sell bonds if the credit quality deteriorates or if cash is needed to fund redemptions. These transactions can result in capital gains or capital loss distributions for shareholders.

Guggenheim

Guggenheim offers corporate bond and high-yield corporate bond ETFs, branded as "BulletShares." Since these

are exchange-traded funds, they can be bought and sold just like stocks through any broker throughout the trading day. This structure means that, unlike with Fidelity funds, there is no minimum investment beyond the prevailing share price. Furthermore, the shares may trade at a premium or discount to net asset value. (On September 10, 2013, the Guggenheim BulletShares 2022 Corporate Bond ETF (BSCM) traded at a 0.57% premium to its underlying net asset value.) The funds are never closed to new investors prior to termination. The expense ratios are 0.24% for the corporate bond funds and 0.42% for the high-yield corporate bond funds.

Ten corporate bond ETFs are offered with maturity dates ranging from 2013 through 2022. The funds are spaced in one-year intervals. These funds intend to hold at least 80% of their assets in bonds that make up an investment-grade corporate bond index. The funds track, but do not exactly mimic, the index. Six months prior to maturity, the objective allows the funds' manager to transition the holdings to cash, U.S. Treasury bills and investment-grade commercial paper.

Guggenheim's six high-yield corporate bond ETFs have maturity dates ranging from 2013 through 2018 and are spaced at one-year intervals. These funds intend to hold at least 80% of their assets in bonds that make up a high-yield ("junk bond") corporate bond index. The funds track, but do not exactly mimic, the index. There are no minimum credit requirements, but the funds' manager will not purchase securities that are in default. During the 12 months prior to maturity, the objective allows the fund's manager to transition the holdings to cash, U.S. Treasury bills and investment-grade commercial paper.

Distributions are paid monthly. Interest from all of the BulletShares ETFs is taxable at ordinary income rates. Though bonds are selected with maturity dates matching the fund's maturity dates, transactions may occur either due to changes made by the funds' manager or due to a bond being called.

As such, capital gains or losses may be distributed to shareholders.

The Guggenheim BulletShares 2012 Corporate Bond ETF (BSCC) and the Guggenheim BulletShares 2012 High Yield Corporate Bond ETF (BSJC) liquidated on December 31, 2012, and distributed cash payments to shareholders of record on December 28, 2012. Guggenheim BulletShares 2012 Corporate Bond ETF distributed short-term capital gains of \$0.0013 per share and long-term capital gains of \$0.0028 per share. Guggenheim BulletShares 2012 High Yield Corporate Bond ETF distributed short-term capital gains of \$0.1467 per share and long-term capital gains of \$0.0552 per share. Keep in mind that taxable distributions from other funds may differ widely from these dollar amounts.

iShares

BlackRock's iShares offers corporate bond and municipal bond ETFs. Just as is the case with Guggenheim's BulletShares, iShares' exchange-traded funds can be bought and sold throughout the day at the prevailing market price. There is no minimum investment beyond the current share price, and the shares may trade at a premium or discount to net asset value. (On September 10, 2013, the iShares 2017 AMT-Free Muni Term ETF (MUAF) traded at a 0.88% premium to its underlying net asset value.) Expense ratios are 0.10% for all of the corporate funds and 0.30% for municipal bond funds.

Eight corporate bond funds are offered with four maturity dates: 2016, 2018, 2020 and 2023. The ex-financials funds exclude debt from financial companies, while the corporate term funds may not. The funds mimic, but do not replicate, investment-grade corporate bond indexes. At least 80% of the funds' assets are invested in individual bonds (domestic and foreign bonds domiciled in developed countries) and other BlackRock affiliated funds. As the fund's termination date approaches (a specific number of months was not listed in the prospectus), proceeds from maturing bonds will be held in cash and

What Happens at Maturity? A Real-World Example

iShares was the first company to offer defined-maturity ETFs. One of its earliest funds, the iShares 2013 S&P AMT-Free Municipal Series ETF (MUAB) terminated in August 2013.

The 2013 fund ceased trading on August 15, 2013, when the last of its bonds matured. (The bonds matured on June 3, June 15, July 1, July 15, August 1 and August 15, 2013.) Shareholders could have bought or sold shares of the fund up until the termination date. Those who held onto the fund were scheduled to receive proceeds, in cash, based on the net asset value (NAV) as of August 15, 2013, on or after August 21, 2013.

iShares instructed shareholders holding the fund in a taxable account to expect to receive IRS Form 1099 in

January 2014. The form may list two classifications of distributions:

- **Liquidation Distribution:** A return of capital that is not taxable to the investor, but each investor needs this number to determine their cost basis to verify if they had a capital gain or loss.
- **Exempt-Interest Dividend:** Not subject to income tax as long as MUAB has more than 50% assets invested in municipal securities. This is the type of distribution the fund has paid since it launched.

Source: "Upcoming Maturity and Planned Liquidation of iShares 2013 S&P AMT-Free Municipal Series (MUAB) Frequently Asked Questions," iShares.

cash equivalent investments, including BlackRock cash funds. Distributions are paid monthly from these funds and are taxable. The funds are intended to terminate on or about March 31 of their respective calendar years.

Five municipal bond funds are also offered. These have maturity dates ranging from 2014 through 2018, staggered at one-year intervals. The funds mimic, but do not exactly replicate, investment-grade municipal bond indexes. The funds invest at least 80% of their assets in bonds issued by state and local municipalities with interest payments that are exempt not only from U.S. federal income tax but also from the alternative minimum tax (AMT). (State tax rules vary.) As a fund's termination date approaches (a specific number of months was not listed in the prospectus), the proceeds from maturing bonds may be invested in cash and cash equivalents, including, without limitation, money market funds affiliated with BlackRock,

AMT-free tax-exempt municipal notes, variable-rate demand notes and obligations, tender option bonds and municipal commercial paper. Distributions are paid monthly. The funds are intended to terminate on or about August 31 of their respective calendar years.

Though the distributions from the iShares muni funds are intended to be tax-free, it is possible that some part of the distributions will be taxable. In addition, any capital gains distributed by the fund to shareholders would be taxable. Finally, an investor would realize a taxable event (a capital gain or loss) if the fund were sold prior to termination or if the payout at termination is more or less than what he paid for the shares.

For example, an investor who had purchased the iShares 2012 S&P AMT-Free Muni Term Bond ETF (MUAA) on January 8, 2010, at \$50.38 per share would have received a final distribution of \$50.62 from the fund's termination on August 15, 2012. The \$0.24 differ-

ence would have been considered to be a long-term capital gain for tax purposes.

Making the Choice

Defined-maturity bond funds are an alternative for individual bonds, but not an exact substitute.

These funds provide access to professional management, diversified bond portfolios and purchasing power. They can also be purchased with different maturity dates and can be laddered.

Defined-maturity funds, however, lack the customization and control of investing in individual bonds, may have tax implications that bonds would not incur and currently do not provide exposure to bonds with maturity dates beyond 10 years into the future. While defined-maturity funds can serve a useful purpose in an individual investor's portfolio, both their advantages and disadvantages should be considered before purchase. ▲

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