Why are investors still flocking to bonds?

Two hints: They're getting older and still feel the burn from bear-markets past.

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Life is full of mysteries. Why are cats terrified of cucumbers? Why does your phone suggest you need a chain saw? And why have investors been putting so much money into bond funds?

The last question is particularly vexing if you hold the notion that individual investors only care about performance. And if you're an adviser, the answer may be in the mirror.

Bond funds have been astonishingly popular, despite an eight-year, rip-snorting bull market. The past five years, investors have poured $634 billion into taxable bond funds and ETFs, according to the Investment Company Institute, the funds' trade group. At the same time, investors have yanked $9.5 billion from domestic stock funds and ETFs.

How has that worked out? For bond investors, not so well. The bellwether 10-year Treasury note yield has risen to 2.31% from 1.61% the past five years. Bond prices fall when interest rates rise: The total return for the Bloomberg Barclays Aggregate Treasury index has been just 1.24% annually for the past five years, less than the 1.30% rise in inflation over the same period.

The Standard & Poor's 500 stock index has gained an average 14.22% each of the past five years. (About $727 billion has gone to international funds, which have gained 5.49% a year over the same period.)

Somewhat startling, if you believe that investors are only interested in returns: The most popular taxable bond fund among investors has been the Vanguard Total Bond Market Index (VBMFX), which has seen estimated net inflows of $73.6 billion the past five years, according to Morningstar Inc. The fund has gained 1.86% a year the same period.

What gives? Let's start with the overall flows to bond funds. Why would investors put so much money into bonds, which have remained mired at levels lower than a mole's sock drawer?

One answer, of course, is fear. Investors have suffered through two soul-searing bear markets since 2000, and the vaunted long-term returns from stocks don't seem terribly exciting if viewed

from a 17-year lens. The S&P has gained 5.10% annually since Jan. 1, 2000, versus 4.79% for the Bloomberg Barclays Aggregate Treasury index. Other factors:

• **Target-date funds.** To avoid double-counting, the ICI doesn't include target-date funds that invest in other funds as part of its overall flows data. Nevertheless, as target-date funds have grown in popularity, their bond-fund purchases have grown as well.

• **Demographics.** "As the wave of baby boomers goes into retirement, it makes sense they would rebalance over the course of their lives for more fixed income," said Sean Collins, ICI's senior director of industry and financial analysis. The median age of baby boomers is 62.

• **Advisers.** One service most advisers offer is systematic portfolio rebalancing. As more investors turn to advisers — or robo-advisers — the more likely they are to rebalance. And as gains from the bull market pile up, those rebalancing moves will tend to push more and more cash into bonds.

On the fund and ETF level, it's not hard to see why investors have chosen Vanguard Total Bond Market. The fund obviously has many charms for investors, not least of which is its 0.15% expense ratio for investors' class shares and 0.03% for the institutions plus share class. Absent an ability to predict interest rates, it makes sense to prefer a low-cost fund, particularly one so popular in 401(k) plans.

The Vanguard offering tracks a variant of the Bloomberg Barclays U.S. Aggregate Bond index, which tilts the fund more toward Treasury securities — 38% — than corporate or mortgage holdings. The result is a fund that fares exceptionally well in a sharp downturn, but at the cost of performance during calmer times.

Could you have done better for your clients' bond holdings? Sure. Pimco Income (PIMIX), which has attracted $70 billion in new assets, has gained 6.9% each of the past five years. A go-anywhere multisector bond fund, Pimco Income is a different animal that Vanguard Total Bond. It has 47% of its assets in securitized mortgages, which offer more yield and more risk than plain-vanilla Treasuries. The argument against the fund is that it's actively managed: Bond managers fare better against their indexes than stock managers, but not by much. Although this fund, too, tends to do well in downturns.

And asset flows aren't always the best way to judge a fund, given the public's fickleness. Pimco Total Return (PTTRX) has beaten Vanguard Total Return the past five years with a 2.43% average annual gain, despite a massive $243 million outflow over the same time and the departure of longtime manager Bill Gross. And Loomis Sayles Strategic Income (NEFZX), which has watched $6 million walk out the door, has gained 5.33% a year the past five years.

As always, the best way to choose a bond fund isn't performance or asset flows, but how it fits your client's needs. Precious few bond funds will meet a client's income needs.

“If you’re after a fund for an income generator, that generator is producing pretty low wattage,” said Jim Lowell, editor of Fidelity Investor. “If interest rates are going to be lower for longer, then it’s going to require some pretty good strategic thinking.

Mr. Lowell recommends broadly diversified active funds, such as Fidelity Total Bond (MTBFX) or its ETF incarnation, FBND. “It’s not a time to be buying a bond index fund,” he said.

Jamie Ebersole, CEO of Ebersole Financial, said experience in a bond fund manager is crucial.

“For those seeking actively managed bond funds, I would steer clients toward those with management teams that have been through several economic cycles and who have had to react to market instability,” he said. “Buying bonds for coupon can be a relatively easy job in benign markets, but managers prove their worth when things don’t go as planned. Managers who haven’t invested in the asset class through a cycle are prone to make more mistakes as everything is new again.”

And if you’re buying a bond fund as a hedge against stock market risk, remember that most bear markets start with a period of rising interest rates. “If interest rates were to rise suddenly, the unwanted kitten in the litter — your cash reserves — will be your best defense,” Mr. Lowell said.