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The Case Against Having a Bond-Heavy Retirement Account

The conventional wisdom is that older investors should have a lot of bonds in their IRAs and 401(k)s. But that may not be the smartest move

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For older investors considering which allocations to overweight and underweight in their retirement accounts, the advice most frequently given by financial advisers for years has been to favor the bonds.

This was good advice once. But not any longer.

No one is saying bonds shouldn't play a big role in our investment portfolios, especially as we get older. Bonds are less subject to big price swings than stocks. They also spin off cash with their regular interest payments, and so can produce much-needed income in one's later years.

But bonds no longer hold big tax advantages when it comes to choosing the contents of an IRA or other tax-sheltered/tax-deferred account. Recent research suggests that the best type of investment to overweight in a tax-advantaged retirement account is an actively managed REIT or small-cap equity fund.

This isn't surprising given that actively managed funds tend to feature more turnover of assets than other types of funds, which contributes to a greater tax bill. That is why it makes sense to hold them in a tax-deferred, tax-exempt and tax-sheltered account like a 401(k), IRA or Roth IRA, where investments grow free of taxes.

In the early 1980s, bonds or fixed-income mutual funds held the advantage, because yields on those types of funds then ranged from 10% to 15%, which on average delivered a bond investor around $125 a year as interest income on a $1,000 investment. A tax-advantaged account could offer substantial benefits by shielding this income, yet with yields now sitting around 2% to 3%, these accounts no longer offer the same advantage to bond investors.

Consider Vanguard Total Bond Market Index Fund (VBMFX). The current yield to maturity of this all-inclusive bond fund is 3.3% and the average coupon rate—the stated interest rate at face value—is 3.1%. Thus on a $1,000 investment, one can expect to earn $31 a year in interest income. If your marginal income-tax rate comes in at 25%, then you are protecting only around $7.75 a year in a tax-deferred retirement account as opposed to holding this fund in a regular brokerage account.

Measuring the benefit

The most accurate way to measure the potential benefit that a tax-sheltered account offers is to examine the difference between a fund's total return minus the return that the same fund would offer after taxes are paid on distributions (also called "posttax return, preliquidation"). This difference captures how much money on an annual basis investors could protect from taxes if they held securities in a tax-deferred, tax-exempt or tax-sheltered account.

Examining this difference in returns for all U.S. mutual funds over the past 10 years shows, first off, that actively managed funds will benefit from being in a tax-sheltered account much more than an index fund will, a fact that holds for actively managed funds across all types of asset classes.

For investors who prefer index funds (to keep the cost of fees down), the asset class that benefits most by being held in a tax-deferred (or tax-exempt) account over the past 10 years is small-cap index funds. By holding such funds in a tax-sheltered account, an investor can protect an extra 1.36 percentage points a year from taxes. Over a 10-year period this can yield an extra 14.5 percentage points in returns.

The REIT choice

For investors who prefer actively managed funds, the best option may be to overweight real-estate investment trusts in your tax-exempt or tax-deferred retirement accounts. The annual return for a REIT held in such an account is 1.73 percentage points higher than the return for the same REIT held in a taxable account (according to a 10-year horizon). Interestingly, fixed-income mutual funds (excluding muni-focused mutual funds) hold only a 1.37-point advantage. This puts the fixed-income funds at the middle of the pack with respect to the other choices and the benefits that they accrue in a tax-exempt account.

The 2018 tax cut may affect these results, especially for REITs. The cut allows individuals to deduct up to 20% of ordinary REIT dividends, with the remainder of the income still being taxed at the investor's marginal rate. There is insufficient data to make an exact calculation at this point, but this suggests that the tax-shielding benefits to actively managed REITs may fall to 1.38 points (using a 10-year horizon).

It may be a long time before bond investors see yields again like those in the 1980s. And because of this it may be a long time before investors see the tax-sheltering benefits for bond mutual funds that they once saw. Tax-inefficient actively managed REITs or small-cap stocks might be the more efficient route for investors deciding what to hold in their retirement accounts.