



Bond ladders vs. ETFs

Tips for selecting an appropriate investment vehicle

Fixed income investments (bonds) can increase diversification in a portfolio and may offer regular income that may be exempt from state or federal taxes (as with municipal bonds and U.S. Treasuries). Two popular ways to access bonds are through bond ladders and fixed income exchange-traded funds (ETFs).

Understanding bond ladders

A bond ladder is a strategy of buying a series of bonds with similar face values and different maturities. This means the bonds will pay similar amounts to the bondholder as they mature on different dates. Compared to a single bond, a series can increase diversification and potentially reduce credit risk, interest rate risk, and reinvestment risk. Also, the investor receives a predictable stream of cash flow.

In a rising interest rate environment, investors can reinvest the principal—ideally at higher yield—as each bond matures. In a falling interest rate environment, investors will still have some bonds with longer maturities in their ladder to maintain higher yields. Eventually, however, investors will need to consider investing at a lower interest rate than they once had.

Another consideration for a bond ladder is the cost. Often, bonds are sold in minimum denominations of \$1,000, which means attaining diversification can add up to a substantial amount.

Key terms

Credit risk. The risk that a bond issuer will default on paying interest and principal.

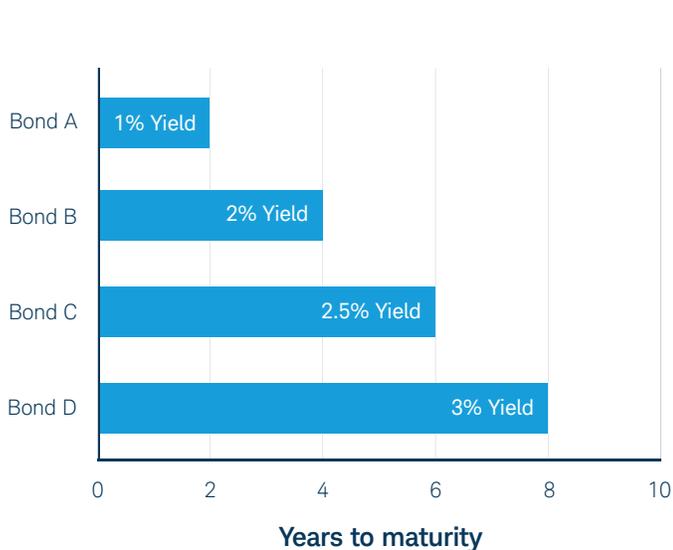
Interest rate risk. The risk that changes in interest rate may reduce the value of bonds an investor holds. Interest rate risk increases the longer the time period remaining until a bond's maturity.

Reinvestment risk. The risk that future cash flows, such as interest payments on bonds, cannot be reinvested at a rate comparable to the current one.

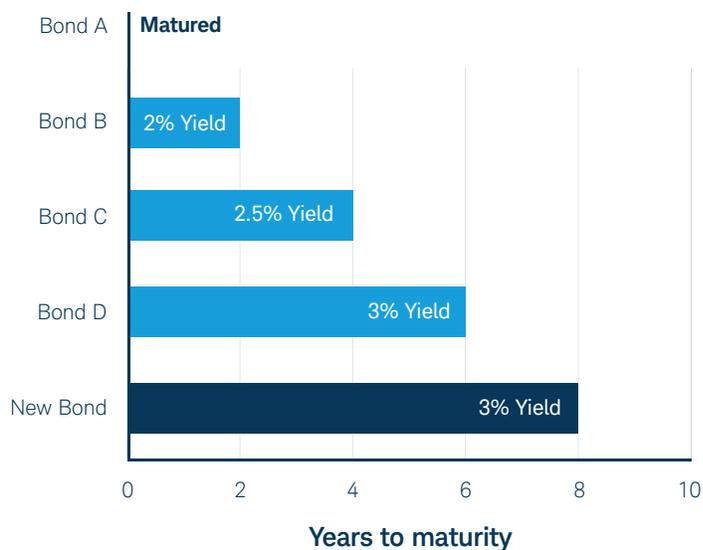
Example of a bond ladder

In step 1 of this example, you buy several bonds with staggered maturities. Here the ladder includes four bonds with a combined average annual yield of 2.125%. In step 2 of this example, bond A matures and you reinvest the proceeds in a new bond, extending the ladder. You can continue to do this as bonds mature in the future.

Step 1



Step 2



This hypothetical example is for illustrative purposes only. It cannot predict or project the return of any specific investments. While predictable, bond income is not guaranteed and is subject to call risk as well as possible default on principal and interest (which increases with lower-rated securities).

Understanding fixed income ETFs

A fixed income ETF is a pooled portfolio of bonds that generally tracks an index of bonds and seeks to replicate or outperform its returns, depending on whether it's an active or passive ETF. The ETF trades on an exchange like a stock, offering several benefits to investors.

Price transparency and liquidity. Because fixed income ETFs trade on an exchange, they offer intraday trading and are continuously priced throughout the trading day, regardless of whether the underlying assets are trading. Price transparency is especially helpful since certain corporate or municipal bonds may go days or weeks without trading because investors tend to buy and hold them for very long periods of time, including to maturity.

Diversification. Investors can gain access to hundreds or thousands of bonds in a fixed income ETF, thus diversifying across issuers and industry sectors, and potentially reducing credit risk.

No maturity. Most individual bonds have a stated maturity date when investors can expect to receive their principal back. In contrast, most fixed income ETFs maintain a weighted average of all bond maturities in the fund, allowing these ETFs to exist in perpetuity without maturing.

Choice of duration. Investors can target the yield curve range they'd like to invest in: short-term, intermediate-term, or long-term.

Monthly income. Because fixed income ETFs hold many different bonds at once, they may pay interest monthly (although the amount may vary). In contrast, individual bonds typically pay coupons twice yearly.

Comparing instruments

	Bond ladder	ETF
Overview	Can provide steady income while reducing exposure to changing interest rates Typically must be purchased directly from a seller because bonds typically trade over-the-counter, which can make pricing less visible	Can help investors diversify in many market segments with one investment May require a brokerage account to buy and sell shares on the exchange
Income frequency	Varies, given that a bond typically pays income twice a year	Usually monthly
Liquidity	May be lower as bonds typically trade over-the-counter	May be higher because ETFs trade like a stock
Ease of use	May be more time intensive to construct and maintain the ladder	May be less time intensive because buying an ETF is like buying a stock on an exchange
Costs	Possible transaction fee	Operating expenses and possible commission
Principal preservation	Principal returned when a bond matures (given the issuer does not default)	Most ETFs do not mature, therefore principal may fluctuate

This is not an exhaustive list and is provided for illustrative use only.

Summary

Bond ladders and fixed income ETFs each have advantages.

A bond ladder may lower interest rate risk and reinvestment risk while giving the investor predictable cash flow. A fixed income ETF may be easier and less expensive than constructing a bond ladder, with greater diversification, price transparency, liquidity, and payment frequency. The decision over which vehicle to use requires thoughtful deliberation and a careful assessment of the investor's objectives, associated risks, and desired time horizons.



We're always here to help

ETF Know:How™ is a full-spectrum curriculum of ETF tools, resources, and insights created for all levels of ETF expertise. This educational program offers you a 360-degree view of ETF investing, with tactical steps to help support your business—from client engagement to portfolio implementation.

To learn more about ETF Know:How and how it can help advance your ETF expertise, call 877-824-5615 or visit schwabfunds.com/etfknowhow.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

A bond ladder, depending on the types and amount of securities within the ladder, may not ensure adequate diversification of your investment portfolio. This potential lack of diversification may result in heightened volatility of the value of your portfolio. You must perform your own evaluation of whether a bond ladder and the securities held within it are consistent with your investment objective, risk tolerance and financial circumstances.

The information and content provided herein is general in nature and is for informational purposes only. It is not intended, and should not be construed, as a specific recommendation, or legal, tax, or investment advice, or a legal opinion. Tax laws are subject to change, either prospectively or retroactively. Individuals should contact their own professional tax and investment advisors or other professionals to help answer questions about specific situations or needs prior to taking any action based upon this information.

©2019 Charles Schwab Investment Management, Inc. All rights reserved.

JUT (0919-9U06) MKT108470-00 (09/19)

00236146

charles
SCHWAB

Investment
Management