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An approach to timing the market that focuses on saving your money

Jeff Brown, special to CNBC.com
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Investors planning for retirement are used to choosing a mix of stocks, bonds or funds to balance risk and reward over the decades. When done right, a properly diversified market portfolio should gain in value over a long time horizon. But not everyone is planning only for retirement. What if you're saving for a shorter-term goal, like buying a second home in the next five to 10 years, building a travel fund for the start of retirement or setting up a safe portfolio for college costs with money that came to you suddenly from an inheritance?

The classic rules of investing need to be adapted for more immediate goals. Otherwise, portfolio gains can be compromised at the very moment an investor needs to make use of them.

"If the client has 10 years in the future before they need the money, then a 60/35/5 (percent) mix of stocks, bonds and cash is the preferred portfolio," said Mark S. Ballard, president of BankChampaign, a wealth management firm in Champaign, Illinois.

But investors with shorter deadlines may find that reliance on stocks too risky. Meanwhile, cash in federally insured bank savings is the other extreme: It is safe, but it is earning so little these days, the investor loses out to inflation.

Individual bonds are the classic alternative. Interest earnings are better than bank savings, and the investor can choose bonds that will mature the year funds will be needed. "For investors who need a specific amount of money on a set date, individual bonds are generally the go-to investment," said David Twibell, president of Englewood, Colorado-based Custom Portfolio Group. "They provide a high degree of certainty, particularly if you hold them to maturity and limit your exposure to issuers with strong credit quality."

Some investing experts are now looking to a relatively new and, to many investors, unfamiliar product: the target-maturity bond ETF. It combines the diversification, liquidity and tax efficiency of a fund with an individual bond's fixed maturity, when the investor is sure of getting back the bond's face value.

Individual bonds can be troublesome for many investors who do not come from a sophisticated financial background.

"Individual bonds often trade at wide bid/ask spreads, which means you could end up overpaying for the bond if you're not careful," Twibell said. Many investors are not comfortable figuring that out or gauging credit quality and interest-rate risk — the danger that a bond will fall from favor and lose value when newer ones offer higher yields. That risk diminishes when a bond approaches maturity, because investors know they'll get back the bond's face amount.

"You can invest in individual bonds to eliminate interest-rate risk by selecting bonds with appropriate maturities, but investors may find it difficult to diversify because of the typical high minimum (purchase requirements) on individual bonds, or they simply find it too complicated to manage a portfolio of many individual bonds," said Matt Hylland of Hylland Capital Management in Virginia Beach, Virginia.

Traditional mutual funds make bond investing easier because professionals pick the bonds, and the funds offer lots of diversification and are easily converted to cash. But traditional bond funds do not have a fixed maturity, because they routinely replace older bonds with newer ones to maintain the average maturity promised to investors. That means the entire fund can lose value if interest rates rise. An investor doesn't know whether they'll get all of their principal back when the deadline arrives.

How you can lose money in bonds

"Clients do not understand that they can lose money in bonds — they view them much like CDs, where a dollar in is a dollar out, plus interest," Ballard said. "With a bond fund in a rising rate environment, the loss that they see on the principal of their investment can equate to multiple years interest earned, depending upon the credit rating and duration of the bonds in the fund."

Duration is a figure, expressed in years, that indicates how much the bond's price can fall for every percentage point rise in rates, with a five-year duration indicating a 5 percent loss for each 1 percent rate increase.

For deadline-oriented investors, "I recommend staying away from open-ended bond funds with no maturity," said Benjamin Lau, co-chief investment officer at Apriem Advisors in Irvine, California. "The constant rotation of bonds in the portfolio makes it difficult to predict the future value of these investments and what they'd be worth when you need them."

Lau said this is the big advantage of target-maturity bond ETFs. "The ETF will target a specific year, say 2018, and buy bonds with that maturity. The goal is to have all the bonds mature in 2018 and shareholders will get paid out the cash before the end of that year."

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"If you need money that you had invested in a long-term bond fund next week, you are likely looking at losses of 15 percent or more from July's highs," Hylland said, blaming he upward creep of interest rates. "Compare that to the iShares 2017 Target Maturity Bond Fund, which is down 0.3 percent over that same period."

Target-maturity bond ETFs typically pay interest every month, and the investor with a deadline can have interest reinvested in more shares. These ETFs can focus on bonds from munis to investment-grade and high-yield corporates, with maturities out as far as 2026.

The Guggenheim BulletShares 2020 High Yield Corporate Bond ETF, for example, allows the investor to avoid interest-rate risk by holding it until 2020, though not the higher default risk associated with junk bonds.

There are some other things to look out for as well.

Interest earnings can drop as bonds in the fund mature during the target year, and the returned principal is held as low-yielding cash until the fund closes. These ETFs don't gain value as ordinary bond funds do when interest rates fall and make older, more generous bonds more attractive to investors, though odds today favor rates rising.

It's important to keep one eye on fees also. While many of these ETFs have low fees around 0.10 percent, Twibell worries about target-maturity bond ETFs charging two to four times that much.

Still, target-maturity bond ETFs offer an alternative to investors with a deadline who don't want the risk of stocks or the stingy earnings of cash and who value a degree of certainty they can't get with ordinary bond funds.

"You have the diversity, professional trade execution, and bond research capabilities associated with standard fixed-income funds, but with the defined maturity of individual bonds," said Nathan Geraci, president of The ETF Store, an Overland Park, Kansas, investment advisory that specializes in ETFs.

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