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Bonds: An Introduction

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What are bonds?

Bonds, sometimes called debt instruments or fixed-income securities, are essentially loans. Corporations often raise money by issuing bonds in addition to selling stock. Governments often use bonds to pay for their ongoing operations or specific projects, such as highways or new construction.

The borrower (the bond issuer) typically promises to pay the lender (the bondholder), regular interest payments until a certain date. At that point, the bond is said to have matured. When it reaches its maturity date, the full amount of the loan (the principal or face value) must be repaid to the bondholder. Each bond pays a stated interest rate called the coupon, a term that dates back to the days when a bondholder had to clip a coupon attached to the bond and mail it in to receive the interest payment. Most bonds pay interest on a fixed schedule, usually quarterly or semiannually, although some pay all interest at maturity along with the principal. In some cases, the issuer can decide to pay back the loan early by calling the bond and repaying the principal before maturity. The specific terms of a bond are set forth in a bond agreement known as an indenture.

Bonds are issued in even denominations, usually of $1,000 or more. Bonds do not need to be held until maturity; they can be traded between investors just like any other type of security. Most bonds are negotiable; when an investor buys a bond, the issuer then owes that investor the bond's interest and principal. When bonds are first issued, the buyer generally pays the exact amount of the bond's face value, in which case the bond is said to be trading at par. A bond can also be traded at a discount (i.e., it is bought for less than its face value). When a buyer pays more than the face value, the bond is said to be selling at a premium.

Some investors prefer to buy individual bonds; others would rather invest in a bond mutual fund or exchange-traded fund (ETF).

Why do investors buy bonds and how can you make money with them?

One of the most important reasons why investors choose bonds is for their steady and predictable stream of income through interest payments. Bonds have traditionally been important for retirees for this reason. Also, though they are not risk-free (e.g., a bond issuer could default on a payment or even fail to repay the principal) bonds as a whole are considered somewhat less risky than stocks, though individual securities have their own specific risks. In part, that's because a corporation must pay interest to bondholders before it pays dividends to its shareholders. If it declares bankruptcy or dissolves, bondholders are also first in line to be compensated.

Bond prices may behave very differently from stocks. For example, when stock prices are down, investors often prefer to invest in bonds; this movement is sometimes called a flight to quality because investors prefer the relative stability that bonds and their interest payments offer. Also, when interest rates are high, the return on bonds can be attractive enough that investors become unwilling to assume the greater risk of stocks.

Because the performance of bonds and stocks is not highly correlated (i.e., the two often behave quite differently), bonds offer significant diversification benefits. The interest from bonds can help balance the ups and downs of your stock investments and increase the stability of your overall portfolio. Also, because a bond's face value gets repaid upon maturity, an investor can choose a bond that matures when he or she needs that money for a specific goal, such as college tuition.

Finally, some bonds offer tax advantages. The interest from bonds issued by state and local governments is exempt from federal income tax, and may be exempt from state income tax as well. U.S. Treasury securities are exempt from state taxes. This can be appealing to taxpayers in high tax brackets.

There are two fundamental ways that you can profit from owning bonds. The most obvious is the interest that bonds pay. However, you can also make money if you sell a bond for more than you paid for it. Some bonds are sold at a deep discount to their face value; the difference between the discounted price and the face value when

the bond is redeemed is the investor’s gain. Also, as with any security, bond prices vary as they are traded in what’s known as the secondary market. They also move up and down in response to investor demand for bonds generally, and to changes in interest rates, though those movements aren't usually as dramatic as the movements of the stock market can be. If you sell a bond before its maturity date, you may get more than its face value, depending on how its interest rate compares to others. However, you could also receive less than the face value if you must sell when bond prices are down. The closer the bond is to its maturity date, the closer to its face value the bond’s price is likely to be.

Overview of bond types

Information about bonds is more widely available to the individual investor than it used to be, but navigating the world of bond trading can be challenging without some guidance. However, the wide variety of bonds also means that you can tailor the income-oriented portion of your portfolio to reflect your needs, investing style, and time horizon.

There are many different types of bonds, and an individual bond usually falls into more than one category. A bond can be categorized by who issues it, by maturity date, by quality, by where it’s issued, by any restrictions or rights it includes, and by whether any collateral backs up the loan.

Investors in a high tax bracket are often interested in tax-advantaged bonds, which can be issued by state and local governments as well as the U.S. Treasury. An equivalent corporate bond would typically pay a somewhat higher interest rate to attract investors. Some bonds, known as high-yield or junk bonds, offer even higher interest rates because they're considered to be at greater risk of default by the issuer. Foreign governments also issue bonds that can be bought by U.S. investors.

Another important way of categorizing debt instruments is by the amount of time until the loan is repaid. Short-term maturities are typically for less than one year; intermediate-term bonds, often called notes, are generally from 1-10 years. Long-term bonds have maturities of more than 10 years. The 30-year Treasury bond is often referred to as the long bond.

Some bonds have characteristics of both bonds and stocks. Others are secured by assets that would be forfeited to the bondholder if the issuer defaults on the loan.

Like stocks, bonds now are typically held in street name, meaning that ownership of a bond is recorded electronically in the brokerage account to which interest and principal payments are made. Such book-entry has become the preferred means of holding bonds. It is replacing so-called registered bonds, which are issued as certificates and are imprinted with the name of the bondholder to whom interest and principal payments are made. Bearer bonds, which are virtually equivalent to cash and do not bear the owner's name, are no longer issued in the United States, though some are still in existence.

What factors should you consider before buying bonds?

As with any security, your bond holdings should be tailored to your unique situation. Your financial professional can help you understand your choices and which options might suit you best. Here is an introduction to some of the factors to consider when evaluating bonds.

Your income needs

If you’re investing in bonds primarily for current income, a bond’s coupon rate will set the amount of your payments. Think about whether you want to receive ongoing periodic income, or are willing to receive much of your return when the bond matures. Some bonds, such as zero-coupon bonds and U.S. savings bonds, pay interest only when the bond is redeemed. Remember that even if you don’t need the income to live on, interest from bonds may help moderate the volatility of your overall portfolio.

Your tax bracket

Tax considerations are especially important for some investors. Some bonds are tax-advantaged. If you're in a high tax bracket, a bond whose interest is generally not taxable by the federal government, such as most municipal bonds, may be a better choice even though the interest rate it pays is lower than a comparable taxable bond. U.S. Treasury securities are generally exempt from income taxes imposed by state and local governments. Also, you'll want to compare the tax you'll pay on bonds compared to what you'd owe in taxes on corporate dividends. Qualifying dividends from corporate stock are taxed at the lower capital gains rates; interest from taxable bonds is taxed at ordinary income tax rates. Absent legislative action, after 2010, dividends will be taxed as ordinary income as they were prior to 2003.

Your time horizon

If you're considering holding individual bonds rather than investing in a bond fund, you'll want to think about how long you intend to hold each one. With individual bonds, you can tailor your maturity dates to when you'll need the money for a specific goal, such as paying for college tuition. You also can sell the bond before it matures, but the price you receive for it may be more or less than the face value, which means you could lose part of your investment. Some bonds pay all interest at the end of the bond's term when the principal is repaid.

Also, it's important to know whether the bond is callable or not. If it is, the issuer can choose to redeem the bond before its maturity date, which means you might not get income for the full period you were counting on. To compensate you for that possibility, callable bonds typically pay a higher interest rate than non-callable bonds. Long-term bonds are especially likely to be callable before maturity.

A bond mutual fund has no specific time horizon, since the fund manager may buy and sell specific bonds at any given time.

When thinking about your time horizon, it's important to consider the impact of inflation. Over time, the inflation rate will affect the value of most bonds and the interest they pay. As prices rise, each dollar buys less and less. Inflation can erode the buying power of both a bond's fixed interest payments and of the principal that will be repaid when the bond matures. As a result, the value of the bond to other investors can drop over time. On the other hand, if deflation occurs, the buying power of your investment dollars is increased and your bond would therefore be more attractive to investors.

Of course, other factors can affect the price of your bond as well. However, because both the interest rate and the face value of the bond are fixed, inflation's impact over time on the value of a bond investment can be greater than on asset classes such as stocks, which generally have more potential to grow in value over time. To help fight inflation, some bonds are designed to adjust both the principal and interest payments automatically based on changes in the Consumer Price Index.

Your resources

As with any type of investment, you'll want to think about diversification (i.e., not having all your eggs in one basket). Diversification doesn't guarantee a profit or ensure against a loss, but if you've invested in bonds from multiple issuers, a default by one of them won't wipe out your entire bond holdings. However, you have to make sure that you have enough money to provide that diversification. If you don't feel you can afford adequate diversification with individual bonds, you might explore a bond mutual fund, an ETF, or U.S. Treasury securities that are backed by the U.S. government.

Also, even though information about individual bonds is more widely available to the individual investor, you may not want to spend the time and effort to research individual bonds.

Your comfort with volatility

Many investors are surprised to find out that even though the face value of a bond remains the same, its value in the marketplace goes up and down. The longer the maturity, the greater the potential changes in a bond's price. You'll need to think about your risk tolerance. Are you willing to accept greater risk for the higher interest rates of a lower-quality bond? Or would you be more comfortable with a lower rate offered by a highly-rated bond or a

Treasury security? Is a longer-term bond with a high interest rate worth the greater fluctuations in price you'll experience, or would a shorter maturity with more stability be better? Your financial professional can help you plot your strategy for balancing return and volatility.

How can you buy bonds?

Bonds are typically bought through intermediaries such as a broker, who has access to both newly issued bonds and older bonds traded on the secondary market. Treasury securities also can be bought directly from the U.S. government through its TreasuryDirect program; a list of auction dates and results is available at www.treasurydirect.gov.

Strategies for bonds: a brief introduction

The variety of bonds available offers you a lot of flexibility in using them to tailor your portfolio to your individual needs and investing style. Strategies for bonds can range from something as basic as buying a bond and holding it to maturity, or earmarking the bond proceeds for a specific need, to strategies such as laddering maturities and bond swapping to achieve a higher yield or a tax advantage.

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