The Name's Bond . . . Just Bond

Nature of Bonds

Objective A

Bring in the Money

When you want to buy something really big—like a skiing trip or a car—how do you get the money you need in a short amount of time? Do you get a larger allowance from your parents? Do you work extra hours at your part-time job? Or, do you ask someone to *lend* you the cash? You might be surprised to learn that many corporations and governing bodies ask for *loans* from people like you and me. Not only are these loans a quick way to bring in a lot of money, they're also a reliable way for you (as an investor) to make your money grow. When a corporation or governing body asks for a loan, it "issues" a bond. A **bond** is a piece of paper (whether real or virtual) that says the governing body or corporation will borrow your money at a particular interest rate for a particular period of time. At the end of the time period, the borrower (or **issuer**) must pay back the money in full—with interest. Sometimes, the interest is paid along the way, providing investors with a steady income. So, how much interest will a bond pay you? And, how often will you get paid? Before you examine the answers to these questions, you need to know the different types of bonds—and who issues them.

Objectives:

Describe the purpose of bonds.

Explain how to buy and sell bonds.

Issuing Bonds

Bonds can be divided into two main segments: government and corporate. Governing bodies issue bonds to fund public programs and projects, while corporations issue bonds to raise money for specific business expenses.

Government bonds. The U.S. government is known for its savings and Treasury bonds. And, local municipalities are known for their municipal bonds, called "munis."

Savings bonds come in Series EE and Series HH. The difference between the two is that Series HH bonds pay interest along the way, while Series EE bonds do not. What makes savings bonds unique is that they are non-marketable. They can't be bought or sold in the open market. Trading (buying and selling) savings bonds is almost strictly between the government and the investor.

The U.S. government also issues **Treasury bonds,** which are classified according to how long each lasts:

- T-bills last less than a year.
- T-notes last one to 10 years.
- T-bonds last more than 10 years.

Treasury bonds *are* marketable—they can be traded as securities in the open market. How is this beneficial to you? When you lend money to the U.S. Treasury through a third party, you have the opportunity to buy the bond at a discount. And, when you sell the bond, you can make a profit from the sale.

Other marketable bonds are **municipal bonds,** offered by municipalities, such as states, cities, or counties. What makes municipal bonds an attractive investment is that they are, in some cases, exempt from certain types of taxes. This means that while investors can receive profits from trading municipal bonds, they

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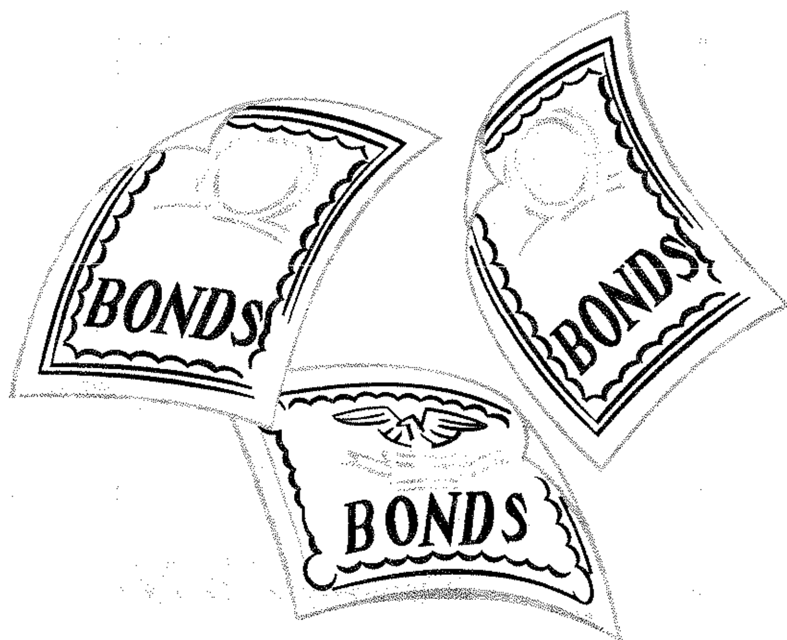
can also receive a sizeable tax break on the interest they receive. Of course, there is a downside: Investors usually receive less interest with a municipality than with a corporation, for instance. The main thing to remember about any government bond is that it is *reliable.* Because governments are long-lasting, they rarely have a problem paying back the money they've borrowed.

Corporate bonds. When corporations issue bonds, they're raising cash they can use right away. So, why don't they just get a bank loan? Many times, banks *do* lend money to corporations, but there is a limit to how much banks will lend and how often they'll lend it. Plus, getting a bank loan can be more expensive. Selling bonds is an easy way for corporations to fund expensive projects—*now.* Overall, the reliability of corporate bonds varies quite a bit. Established corporations issue bonds that have a



high likelihood of being repaid—and that are considered reliable. But with unstable corporations, repayment is not as likely, and the bonds are considered risky. Since corporate bonds are marketable, investors routinely trade them before their maturity dates to make a profit.

Income From Bonds

So, let's get to the nitty-gritty: What does a bond pay you? A bond investment operates inversely (in an opposite way) from the stock market. When stock prices rise, bond prices fall. And, when investments in the stock market earn a higher interest rate, bond interest rates *don't* rise in comparison. This may seem like a downside, but it's not necessarily. A bond—unlike a stock—can have a fixed rate of interest, paying the lender a steady sum of money, regardless of stock variations. This reliability attracts cautious investors who expect an uncertain economy.

A bond's interest rate is called the **coupon rate.** This name comes from the old-fashioned way of distributing bonds—with coupons attached. On each payment date, investors visited a bank to exchange a "coupon" for their interest payment.

Nowadays, you receive your interest payment without submitting a "coupon." How *often* you receive your payment varies according to the bond you have. With a twice-a-year payment, a bond that earns 4% pays out 2% in the first half of the year and the other 2% in the second half. However, not all bonds pay interest twice a year. Some hold the interest until the end of the time period, and some allow you to reinvest your interest along the way.

With what we've looked at so far, bonds seem to be pretty straightforward. You lend your money to a governing body or a corporation, and you receive regular interest payments until the **maturity date**—when you can claim your original investment. But, there's more to it than that. As you consider investing in bonds, you want to look at the repayment terms, too.

When it comes to repayment, a bond can be straight, callable, or puttable. Straight bonds are the straightforward kind: Your money (called the **face value** or **par value**) is repaid on the maturity date. A bond that is returned *earlier* than the maturity date is either callable or puttable (or both). Callable bonds have a call date (or dates) when the issuer can "take back" the agreement in order to sell the bonds to someone else—at a lower interest rate, for instance. Puttable bonds allow you as the lender to "take back" the agreement and invest your money at a higher interest rate, somewhere else. As an investor, you want to be able to "put" your bond, if you discover a better investment opportunity. But, you don't want a corporation to "call" a bond you hold—because you'll miss out on the steady interest payments you could have received.

When bonds are called or put, they can usually be bought or sold as any other marketable bond—at par value, above par value (at a premium), or below par value (at a discount). Of course, investors in the open market want to buy low and sell high! With this plan of action, investors can increase a particular bond's potential income.

To Invest...or Not to Invest?

When you make the decision to invest in a bond, you want to know what you're getting into before you begin the process. You want to know the benefits and the drawbacks of lending your money to a governing body or corporation.

Pros and Cons

In general, bonds have benefits that can't be duplicated by other investments:

- They offer unmatched reliability.
- They help you meet long-term goals—or short-term ones, if you prefer.
- And, they perform well when the economy is poor.

You might think, "What more do I need?" Well, if you *do* want a few more benefits, you can buy secured bonds—those that are backed by collateral (a pledged item) or those that are backed by a mortgage. Both types assure you the loan will be repaid, even if something goes wrong. In addition, if you want to take advantage of rising interest rates, you can buy convertible bonds—those that can change into a stock when the economy does well.

Bonds carry some risks, however. With interest-rate risk, the longer you hold a bond, the more likely it is that the market's interest rates will change significantly by the time the maturity date arrives. This change may or may not be in your favor. If it's not in your favor, you can't sell your bond before the maturity date without losing out on potential income.

2.75% 4.63% 6.12%

Interest-rate risk isn't the only risk associated with bonds. Liquidity risk and repayment risk are also important to consider. Both have to do with how quickly you get your money back. If you need to access your money sooner rather than later, you want a fairly *liquid* investment. And, if you prefer to keep your money in an investment for a long time, you want to avoid anything callable because your bond might be *repaid* earlier than you want.

Another risk is default—not getting your money back at all. You might encounter default risk when:

- An event, such as a natural disaster, prevents a company from meeting its financial promises.
- A company doesn't pay its bills on time (or at all).

While you can't prevent a natural disaster, you can check up on a company's bill-paying habits by examining its bond rating. A **bond rating** is a "letter score" assigned to a company based on the financial responsibility it has demonstrated. If a company is assigned "AAA," for example, it's very reliable. If a company ranks as a "C," however, it may default on the loan.

In short, a bond's risks are really quite tame compared to the risks of other types of investments. And, because of this, many investors feel that bonds—and their benefits—are well worth it. In particular, investors like the stability bonds offer in relation to stocks when both are included in a strategic investment plan.

What's on the Table?

So, now that you know the pros and cons of investing in bonds, how do you make an informed buying or selling decision? You start by examining the facts listed in a bond table. To find a bond table, acquire a well-known financial newspaper, such as *Barron's* or the *Wall Street Journal*.

A basic bond table can look like this:

Issuer	Coupon	Maturity	Bid $	Yld %
Sprint	8.375	Mar 15, 2012	117.365	5.169
Verizon	5.850	Sep 15, 2035	97.779	6.010
Wal-Mart	7.550	Feb 15, 2030	127.002	5.520
Target	5.375	Jun 15, 2009	102.493	4.630

Source: *Wall Street Journal*, October 5, 2005

Across the top of the bond table are column headings. The headings vary a bit, depending on which source you use. But, the information is pretty much the same—covering many of the same points, such as "Issuer," "Coupon," "Maturity," "Bid Price" (or "Bid $"), and "Yield" (or "Yld %" or "YTM"). The headings represent the components of the bond table, and each component has a specific purpose or function.

Issuer, coupon, maturity. You should be familiar with the first three components already, but let's review them briefly.

- The bond's *issuer* is the governing body or corporation borrowing your money. If the name of the issuer is too long to fit in the space available, it can be shortened. For example, Coca-Cola can be listed as Coke.
- The *coupon* is the interest rate the bond will pay to you, the lender. This interest rate is printed to the thousandths' place for accurate comparisons.
- The bond's *maturity* is the date when the loan must be repaid. It can be listed as month-day-year (Mar 15, 2012) or just month-year (3-12).

Who's borrowing from you, how much you'll get in return for your loan, and when you can expect your money back are certainly important facts to identify before you buy or sell bonds.

Bid price and yield. The remaining components, while not as familiar, tell you some pretty important information, too. The *bid price* tells you what others are willing to pay for the bond, and the *yield* tells you how much you can expect to get out of the bond altogether.

When you look at the **bid price** of a bond, you see how much others are willing to pay for every $100 of the bond's par value. If $93.90 is the bid price, buyers are willing to pay only 93.9% of the bond's par value. In contrast, if the bid price is $101.55, buyers are willing to pay 101.55% of the bond's par value. If you're buying a bond, you want the bid price to be under $100. But, if you're selling a bond, you want it to be over $100. Through buying low and selling high, you can make money from your bond investment.

The **yield** is what the bid price and the coupon rate together would (or could) bring you in interest over the time period. In other words, if you: (a) take the amount of money the bond is worth right now (the bid price), (b) include the interest you could earn from it at the current interest rate, and (c) figure out how much the two will bring you in theory each year at this bid price—you have a good idea of what your yield percentage is. The actual mathematical calculation for yield percentage is more complex than this, but you don't need to learn the calculation right now. You just need to know where to find the yield on a bond table.

Standard & Poor's

FitchRatings

Who rates corporate bonds? Standard & Poor's, Fitch Ratings, and Moody's Investors Service.

Selecting and buying. Once you've examined the bond tables in the newspaper, you're ready to investigate how you want to go about buying a bond. If you prefer to buy a T-bill or T-note, you might purchase directly from the U.S. Treasury through an online account with Treasury Direct. If you're interested in buying a particular corporate bond, you might purchase through a broker (someone who buys securities for resale). Keep in mind that buying "direct" is typically cheaper than buying through a broker—because brokers usually require a fee.