Bonds

When an individual borrows money to purchase a home, a type of debt called a “mortgage” is created. A single organization such as a bank or credit union will loan money to the homeowner, who, in return, makes monthly payments to pay off the loan. Each monthly mortgage payment is part interest and part principal.

When an institution such as a government, a government agency, or a corporation wants to borrow money, it can do so by creating a form of debt called a “bond.” Rather than going to a single source for the money, institutional borrowers will sell bonds to many separate investors. In return, investors receive periodic, interest-only payments, with the principal amount of the bond being repaid in a lump sum, no later than a specified future date.

Types of Bonds

There are two basic ways to classify bonds:

- **Bond issuer:** The federal government, state and local governments and agencies, and corporations all issue bonds.

- **Maturity:** Refers to the date when the money borrowed must be repaid. Bond maturities can range from one to 30 years.

The Language of Bonds

There are a number of terms investors use when discussing bonds:

- **Form:** Bonds are issued in many different forms. If a bond is “registered,” a bond certificate is issued, listing the name of the owner. The bond issuer sends the interest payment to the owner when due. Some bonds are “bearer” bonds; whoever bears (has possession of) the bond is presumed to be the owner. The “book-entry” form is usually used for very short-term bonds. No certificate is issued; the bond issuer keeps a list of the owners, and sends an informal statement to each to confirm ownership.
- **Denomination:** Refers to the amount to be repaid when the bond matures. The terms “face value,” “par,” and “par value” are also used. Bonds are most commonly issued in $1,000 denominations.

- **Yield:** The annual return on a bond. For example, an investor who pays $1,000 for a bond paying $60.00 per year has a 6.0% yield. The term "coupon" is also used. Early bonds were issued with a sheet of coupons attached. To receive his interest payment, an investor would clip one of the coupons and return it to the issuer. Zero coupon bonds do not pay interest currently. Instead, such bonds are issued at a discount from face value. The investor receives principal and interest in a lump sum at maturity. Floating rate bonds have a yield that can change under specified circumstances.

- **Credit rating:** Before a bank makes a mortgage loan, it does a credit check to gauge the prospective borrower's ability to repay both principal and interest. The risk that a debt will not be repaid is termed "default" risk. Investors can estimate the probability of default in a particular bond by checking an issuer's credit rating. Moody's Investors Service and Standard and Poor's are two well-known bond-rating agencies. In general, the higher the credit rating, the lower the default risk. A bond issuer's credit rating can change over time.

Bond Prices and Interest Rates

If an investor buys a bond, and holds it to maturity, the issuer is obligated to repay the full face amount. If a bond is sold before it matures, however, the investor may receive more, or less, than originally paid. Bond prices can move up and down, usually in response to changes in the general level of interest rates. If rates rise, the price of existing bonds usually falls; if interest rates decline, the market value of existing bonds generally increases. Other factors may also affect bond prices.

Bonds and Income Taxes

The income tax treatment of bond interest depends primarily on who issued the bond:

- **U.S. government bonds:** Interest from direct obligations of the U.S. government is taxable by the federal government, but is generally exempt from tax at the state and local level.

- **Municipal bonds:** Income from municipal bonds is generally exempt from federal tax. Normally, the interest is also exempt from state and local taxes if the bondholder lives in the same jurisdiction where the bond was issued. In some cases, income from municipal bonds may be subject to the alternative minimum tax (AMT) as well as capital gains taxes.

- **Corporate bonds:** Interest income from corporate bonds is generally taxable by the federal government and state and local governments.

Investment Uses

Bonds are most frequently used as a stable, predictable source of current income. The favorable tax treatment of U.S. government and municipal bond interest is a plus.

How to Invest

- **Direct ownership:** Working with a stockbroker or other securities-licensed professional, investors can buy bonds directly, holding the securities in their own names.
- **Indirect ownership:** Open-end investment companies known as mutual funds are an indirect method of bond ownership. Mutual funds pool the resources of many individuals, and offer an investor access to a diversified, professionally managed portfolio. Exchange-traded funds, or ETFs, are a variation of the standard mutual fund, and are another way of investing in bonds. Unit Investment Trusts (UITs) are a third form of indirect bond ownership. The bond portfolio in a UIT is fixed and not actively managed.[1]

Possible Risks

- **Market risk:** If a bond is sold before maturity, an investor may receive more or less than originally paid.
- **Default risk:** An issuer may default on payment of the principal or interest of a bond.
- **Inflation risk:** As fixed return investments, bonds are subject to inflation risk; over time, the dollars received have less purchasing power.

[1] The Securities and Exchange Commission requires that all prospective UIT, ETF, and mutual fund investors be given a prospectus. The prospectus contains valuable information concerning how an investment works, its goals and risks, and any expenses and charges involved.

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