

Financially Speaking
With Trisha Arndt, CFP®

The ABC's of Bonds

Traditionally when investing is discussed there are two primary types of investments referenced – stocks and bonds. Last month I wrote about what a stock is and explained how owning a share of stock really means owning a piece of a company. This month I want to spend some time defining bonds.

To prepare for this column I decided to do a little bit of un-scientific research by asking a few non-financial people to tell me how they would define a bond. What I discovered is that a large number of people really don't have any idea what a bond is. I heard things like “more conservative than stock” or “pays interest” but no one I asked could actually tell me what a bond is.

So let me start from the beginning. A bond is a loan. A lump sum of money is given upfront and in exchange for the use of the money the borrower agrees to pay interest and return the principal.

Bonds are generally used as a tool for borrowing money when the dollar amount involved is more than could be efficiently borrowed from one source (i.e. when more money is needed than what could be borrowed from a bank). The borrower (bond issuer) is generally either a corporation or a government entity. In fact, the deficit of the United States is funded by bonds – we don't owe those trillions of dollars to some mythical bank out there. The money is owed to anyone who buys treasury bonds – possibly even you. Government bonds are guaranteed only as to timely payment of principal and interest and do not eliminate market risk.

When a corporation or government entity has a need for a large sum of money for an extended period of time (perhaps to fund building a new manufacturing facility or a new toll bridge) they may decide to borrow the money for the project by issuing bonds. Similar to a stock IPO, an investment bank is used to facilitate the process but basically the bonds are made available for purchase by investors. In the United States bonds are generally issued in \$1000 increments – in other words you buy one bond for \$1000 if you buy it at initial issue.

The specific terms of a bond's interest payments and schedule for returning principal can take on many forms. Unlike a traditional bank loan, most bonds do not provide for payments that include both interest and principal. Instead, bonds often pay a set amount of interest, called the coupon, each year and then return the principal in a lump sum at the end of the term, called the bond maturity.

The level of a bond's coupon (i.e. the amount of interest it pays) is dependent upon the financial position of the issuer. Just like a bank determines what interest rate to charge

on a car loan by the borrower's credit score, so too do investors determine the level of interest needed to buy a bond of a given entity based on the entity's financial health. The better the financial health of the borrower, the less interest will be required. Interest income may be subject to the alternative minimum tax. Corporate Bonds contain elements of both interest-rate risk and credit risk. One gauge of the creditworthiness of an entity is the Standard and Poor's rating – the rating that was famously downgraded for the federal government this summer.

Investors typically buy bonds for the income they may provide. Often a higher level of interest can be earned from a bond than from bank accounts like money markets or CD's. Investors need to keep in mind however that while the coupon payment paid by most bonds is fixed, it is only as secure as the entity issuing the bond.

Because bonds are securities, they trade on the open financial markets and therefore fluctuate in value during the period between issue and maturity. The closer a bond is to maturity the less the value will fluctuate and the closer it will come to par (generally the same \$1000 as the issue price because it represents the return of principal). Some bonds have call features that may affect income.

Just knowing what a bond is doesn't necessarily qualify someone to invest in them. There are a lot of important considerations to factor in when selecting any investment and bonds are no different. Please keep in mind that the purchase of bonds is subject to availability and market conditions. Generally, the bond market is volatile, meaning, bond prices rise when interest rates fall and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. In this environment of historically low interest rates I find that a lot of people are looking to bonds as an alternative to CD's. While doing so can make sense in certain situations, it is important to understand the differences between the two. Next month I will address those differences and also go through some common misunderstandings people have about bonds.

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