

Understanding Bonds

A look at their benefits and risks

Topical Education for Today's Investor

RISK MANAGEMENT

A bond is an “IOU” for money loaned by an investor to the bond’s issuer. In return for the use of that money, the issuer agrees to pay interest to the investor at a stated rate known as the “coupon rate.” At the end of an agreed-upon time period when the bond “matures,” the issuer repays the investor’s principal.



An Introduction to Bonds

Because bonds do not always move in tandem with stock investments, they help provide diversification in an investor’s portfolio. They also provide investors with a steady income stream, usually at a higher rate than money market investments.¹ Zero-coupon bonds and Treasury bills are exceptions: The interest income is deducted from their purchase price, and the investor then receives the full face value of the bond at maturity.

Some bonds hold “**credit risk**,” or the risk that the bond issuer will go into default before your bond reaches maturity. In that case, you may lose some or all of the principal amount invested and any outstanding income that is due. Bonds are often rated by organizations such as Moody’s and Standard & Poor’s (S&P). Ratings run from Aaa (Moody’s) or AAA (S&P) through D, based on the issuer’s creditworthiness. Aaa and AAA are the highest credit ratings.

Despite their unpleasant name, junk bonds (so-called because of their lower credit ratings) are fairly common investment vehicles. They are most appropriate for investors who can withstand price volatility in search of higher yields and the increased risk of losing some or all of their original principal investment.

Like stocks, all bonds can present the **risk of price fluctuation** (or “market risk”) to an investor who is unable to hold them until the maturity date (when principal and interest are repaid to the bondholder). If an investor is forced to sell or liquidate a bond before it matures, and the bond’s price has fallen, he or she will lose part of the principal investment as well as the future income stream.

An Inverse Relationship: Interest Rate Risk

Another risk common to all bonds is **interest-rate risk**. When interest rates in the economy rise, a bond’s price will usually drop, and vice versa. Historically, bond investments have been more stable than their stock counterparts due to the steady stream of income received. Moreover, because bond investors may be concerned primarily with receiving income (instead of capital appreciation) from their bonds, they may not be as concerned with fluctuating bond prices. Many bond investors will hold their bonds until maturity, intending to receive their principal investment.

Know the Risks Associated With Bonds

- **Credit Risk** – The risk that a bond’s issuer will go into default before a bond reaches maturity.
- **Market Risk** – The risk that a bond’s value will fluctuate with changing market conditions.
- **Interest Rate Risk** – The risk that a bond’s price will fall with rising interest rates.
- **Inflation Risk** – The risk that a bond’s total return will not outpace inflation.

Types of Bonds

Bonds come in a variety of forms, each bringing different benefits, risks, and tax considerations to an investor’s portfolio. Most U.S. bonds fall into four general categories: corporate, government, government agency, and municipal.

■ Corporate Bonds

Issued by corporations, these bonds can provide an investor with a steady stream of income at a generally higher rate than other bonds.

Risk Considerations: Other than market and interest rate risk, the primary risk associated with this type of bond is credit risk. Another risk with some corporate bonds is that the bond could be “called” by the issuer, who then repays the principal before the maturity date; the debt is paid ahead of time, and the investor may not be able to reinvest it at the same income stream.

Tax Considerations: All interest earned on a corporate bond will be taxed as ordinary income at your usual income tax rate. If you choose to sell a bond for profit, this “capital appreciation” will be taxed as a capital gain.

■ Government Bonds

Government bonds are issued by the U.S. Treasury and backed by the full faith and credit of the U.S. government. They include intermediate- and long-term Treasury bonds. Intermediate-term bonds mature in 3 to 10 years, whereas long-term bonds generally mature in periods of up to 30 years.

Risk Considerations: Perhaps the lowest risk of all bond investments, these bonds have little credit risk because they are guaranteed by the U.S. government. A government bond does present market risk if sold prior to maturity, and also carries some inflation risk — the risk of its comparatively lower return not keeping pace with inflation.

Tax Considerations: Treasuries are fully taxable at the federal level but are exempt from state and local taxes.

■ Government Agency Bonds

These bonds are indirect debt obligations of the U.S. government issued by federal agencies and government-sponsored entities. Examples of such organizations are the Federal National Mortgage Association (FNMA or “Fannie Mae”), the Government National Mortgage Association (GNMA or “Ginnie Mae”), and the Student Loan Marketing Association (SLMA or “Sallie Mae”).

Risk Considerations: Next to Treasury bonds, agency and entity bonds are the second safest bonds in terms of credit risk. Because these bonds are not directly issued by the U.S. government, they are not necessarily backed by its full faith and credit. In addition to the risks inherent in government bonds, agency bonds run the risk of going into default, although such an occurrence is highly unlikely. Due to this added risk, however, these bonds generally offer higher yields than government bonds.

Tax Considerations: These bonds are fully taxable at the federal level and, in some cases, at the state and local levels as well.

■ Municipal Bonds

Municipal bonds, or “munis,” are issued by a U.S. state, county, city, town, village, or local authority to raise funds for general use or particular public works projects.

Risk Considerations: Munis fall somewhere in the middle of the credit risk spectrum. The risk of default can vary depending on the creditworthiness of the issuer and the type of debt obligation.

Tax Considerations: Perhaps the biggest advantage of most munis is their tax-exempt income status. Income accrues tax free at the federal level and, in most cases, at the state and local levels as well. Capital gains, on the other hand, are fully taxable.

Individual Bonds vs. Bond Mutual Funds

Many bond investors pursue their goals through mutual funds because individual bonds require initial investments ranging anywhere from \$1,000 to \$100,000 and because buying/selling bonds is not as efficient (and therefore, often more costly) as trading most stocks. Providing the professional management and diversification inherent to all funds, bond mutual funds can offer a fixed-income element to balance out a portfolio of other stock and money market investments. Investors should remember, however, that bond funds do not mature; therefore, risk to principal cannot be minimized by holding them to maturity as with individual bonds. Also, although interest income and the principal amount invested in government bonds is guaranteed, the funds that invest in these bonds are not.

Although bonds are often listed second to stocks when it comes to long-term investing benefits, their variety (and, in some cases, their tax benefits) can be suitable to many investors. Discuss your goals with your financial advisor, and together you can decide whether bond investing is right for you. When investing in bonds, also keep in mind that the federal alternative minimum tax (AMT) rules could apply.

Points to Remember

1. A bond is an “IOU” from an issuer to an investor.
2. A bond’s issuer agrees to repay the investor the principal amount invested at the bond’s maturity date, along with regular interest payments at the bond’s stated coupon rate.
3. Bond risks include credit risk, market risk, interest-rate risk, and inflation risk.
4. Most U.S. bonds fall into four general categories: corporate, government, government agency, and municipal.
5. Some investors might best pursue their fixed-income goals through bond mutual funds, although they should remember that while government bonds guarantee principal and interest, the funds that invest in them do not. Also, bond funds do not mature; therefore, risk to principal cannot be avoided by holding the bonds to maturity.

For more information, please consult with your financial advisor.

Important Additional Notes

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1 An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

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