BONDS

Bonds have long been considered the boring, poorer performing alternative to stocks. However, in most portfolios, there is an important role to be played by bonds and it is crucial to understand the nature of this alternative to the stock market.

A bond is basically a loan. The owner of a bond has given the issuer – whether it be a corporation, a government or another agency – a sum of money that can be used at any point. In exchange, the issuer will pay interest to the bondholder over a period of time and will eventually return the initial amount loaned, called the principal. Unlike a stock, the bondholder does not own a part of the company. Because a bond is basically a loan, they are often called "debt securities" because they represent a debt obligation from the issuer to the bondholder. Bonds are also known as fixed income securities. The reason for this name is that at the time of the purchase of a basic bond, the amount of income and the timing of the payments are known to the purchaser.

Here are the items that will be specified on most (but not all) bonds:

- **Time to Maturity** – This is the date the issuer will make a lump sum payment to return the principal to the bondholder, which eliminates the debt.
- **Principal, par value, face value** – These are three names for the same item, the amount that will be returned to the bondholder at maturity. The most common face value is $1000.
- **Coupon** – This is the interest payment that will be made to the bondholder. Generally, a percentage of the face value will be fixed which will represent the annual interest rate on the loan. Also, a timetable will be set up for the payment of the coupons, usually semiannually. Not all bonds pay out interest through coupon payments.

There are really two markets for bonds: the primary market and the secondary market. The primary market is when the bond is first issued. In the primary market the bond is purchased directly from the issuer (the details of buying and selling bonds will be covered later). The secondary market occurs later,

when bonds are sold from one bondholder to another. The prices on bonds in the secondary market are set by supply and demand and are impacted by what is expected of interest rates and inflation, how many coupon payments are left to maturity, and how long it will be until the bond matures. There are many types of bonds. The different types of bonds are usually defined by the issuer, though some are defined by the characteristics of the bonds. These topics are covered in detail throughout the rest of this section, but here is a quick list of some of the major types of bonds:

Bonds issued by a corporation are called **corporate bonds**. When a company needs to raise funds for some type of investment or expenditure, they often turn to the public markets for funding. One way to do this is to issue additional stock in the company, but this has implications on the value of the shares and dilutes ownership. The other major option is to sell bonds to the public and take on debt.

Municipal bonds are bonds issued by any municipal organization including cities, counties, states, and school districts. The purpose of these bonds is for general expenditures or to fund specific projects such as highways, new schools, or an athletic stadium. These bonds offer the municipality the opportunity to raise funds without directly raising taxes. Of course, the funds needed to repay the bonds will often come from a tax increase. The main appeal of municipal bonds is that the interest payments are usually exempt from federal taxes. However, capital gains that occur when the bond is sold or at the time of maturity (if the bond was bought at a discount) are not exempt from any taxes.

Treasury bonds are issued by the government of the United States in order to pay for government projects. The money paid out for a Treasury bond is essentially a loan to the government. As with any loan, repayment of principal is accompanied by a fixed interest rate. These bonds are guaranteed by the 'full faith and credit' of the U.S. government, meaning that they are extremely low risk (since the government can simply print money to pay back the loan). Additionally,

interest earned on Treasury bonds is exempt from state and local taxes. Federal taxes, however, are still due on the earned interest.

Zero-Coupon Bonds Some bonds, called zero coupon bonds, don't pay out any interest prior to maturity. These bonds are sold at a deep discount because all of the value from the bond occurs at maturity when the principal is returned to the bondholder along with interest. These bonds are also known as "zeros." One type of zero-coupon bond is a "strip." The interest payments are separated from a bond's principal and multiple zero coupon securities are created, one representing the principal amount and one representing each coupon payment. A problem with zero-coupon bonds is that, even though you do not receive any interest payments during the time you hold the bond, you are still responsible for paying taxes on the suggested interest you are earning. The taxes are based on the appreciation of the bond's market value, which will increase consistently as it approaches maturity. Zeros are also more volatile than bonds that have regular interest payments. The main benefit of zero coupon bonds is if you are saving for a specific event that will occur at a specific time, such as paying for college. You can purchase the zero coupon bonds to mature just before you will be needing the money.

Junk Bonds Corporate bonds are very common and you can find prices and other information in the financial or business sections of major newspapers. Most corporate bonds have a par value of $1,000 and carry various maturity dates. Generally, these bonds pay higher rates than government or municipal bonds due to the increased risk. Corporate bonds have a wide range of ratings and yields because the financial health of the issuers can vary widely. All companies are different and have a different likelihood of defaulting on their obligations. For example, an old economy blue chip is far less likely to default than a new technology company. The blue chip's bonds might carry an investment-grade rating, such as AA. Meanwhile, the less stable company might issue bonds rated in the junk category. These junk or "high yield" bonds might look like the superior investment on paper because they will command a higher yield for the bondholder.

However, taking into account the increased risk of default (which would result in the bondholder going unpaid), these bonds might not be worth the risk.

If a company goes bankrupt, both bondholders and stockholders can make a claim on the company's assets. However, one of the benefits of being a bondholder is that your claim takes precedence over that of stockholders in a liquidation situation. Additionally, some corporate bonds are "secured." This means that the debt obligation is backed by some asset that can be liquidated in order to pay off the interest and principal. Corporations will often issue mortgage bonds, which are backed by real estate or physical equipment. These bonds are safer than unsecured bonds, which are backed only by the "full faith and credit" of the company – which basically means you are taking their word for it.

Most corporate bonds are straightforward with a fixed coupon rate that doesn't change until maturity. There are some variations, however. Some bonds will have a floating rate, which means the interest paid in the coupon will be pegged to some independent index like the money market interest rate or the rate on a short term Treasury Bill. While these bonds insure you against a change in interest rates, they tend to offer lower yields. Another type of bond that might be issued is a zero coupon bond, which has no interest payments at all prior to maturity

The way in which these factors interact with your investment goals and risk tolerance should provide the necessary guidance to make the proper investment.

🗝 8.2 VOCABULARY NOTES AND COMMENTARIES

bond облігація

corporate bond корпоративна облігація

junk bond втратна облігація

Treasury bond довгострокова облігація державної скарбниці

zero-coupon bonds безкупонна облігація; цінний папір, який не приносить відсотків (продається із знижкою проти номіналу, таким чином утримувач одержує дохід при її погашенні за номіналом)

municipal bond муніціпальна облігація

callable bond облігація на вимогу

par value *syn* principal, face value номінал

maturity строк погашення; дата погашення

convertibility конвертованість; оборотність