A Primer for Investing in Bonds

By the Editors of *Kiplinger's Personal Finance* magazine

Bonds

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About the Investor Protection Trust

The Investor Protection Trust (IPT) is a nonprofit organization devoted to investor education. Over half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993 the Investor Protection Trust has worked with the States and at the national level to provide the independent, objective investor education needed by all Americans to make informed investment decisions. The Investor Protection Trust strives to keep all Americans on the right money track. For additional information on the IPT, visit www.investorprotection.org.

Kiplinger's PERSONAL FINANCE

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A BOND IS BASICALLY A LOAN made by a corporation or government with the money used for a specific project such as a plant upgrade or a new bridge. The issuer pays the bondholder a specified amount of interest for a specified time, usually several years, and then repays the bondholder the face amount of the bond.

Bonds may belong in your investment plan for good reasons:

- **Economic forces that depress stock prices**—the early stages of a recession, for instance—tend to boost bond prices. (The opposite also tends to hold true: When the stock market rises, often due in part to falling interest rates, bond prices often fall.)
- **Bonds can generate impressive profits** from capital gains. Sometimes you can even calculate those gains years in advance on the day you buy the bonds.
- **Bonds can provide a predictable stream of relatively high income** you can use for living expenses or for funding other parts of your investment plan.
- **Some kinds of bonds offer valuable tax advantages** and unparalleled opportunities to take advantage of the time value of money, that is, to invest a modest amount with a reasonable prospect of collecting a large amount a few years later.

Note that the word "safety" doesn't appear in this list. A lot of people think bonds are about the safest investment around, but as you'll see, such a notion may not always be correct.

How Bonds Work

Bonds are IOUs issued by corporations, state and city governments and their agencies, and the federal government and its agencies.

When you buy a bond, you become a creditor of the corporation or government entity; it owes you the amount shown on the face of the bond, plus interest. (Bonds typically have a face value of $1,000 or $5,000, although some are larger.) You get a fixed amount of interest on a regular schedule—every six months, in most cases—until the bond matures after a specified number of years, at which time you are paid the bond's face value.

If the issuer goes broke, bondholders have first claim on the issuer's assets, ahead of stockholders.

In most cases, you won't receive the actual bond certificate. Bond ownership usually is in the form of a "book entry," meaning the issuer keeps a record of buyers' names but sends out no certificates. Treasury bonds, for instance, are issued in book entry form.

A long-term bond typically matures in 20 to 40 years, although there are some that are issued for shorter periods. A bond that is due to mature in three to ten years is called an intermediate-term bond. Short-term bonds generally mature in three years or less.

A bond is basically a loan made by a corporation or government with the money used for a project.

After bonds are issued, they can be freely bought and sold by individuals and institutions in what's called the secondary market, which works something like a stock exchange.

All bonds share these basic traits, but they come in a variety of forms. Let's take a closer look.

Types of Bonds

Secured bonds are backed by a lien on part of a corporation's plant, equipment or other assets. If the corporation defaults, those assets can be sold to pay off the bondholders.

Debentures are unsecured bonds, backed only by the general ability of the corporation to pay its bills. If the company goes broke, debentures can't be paid off until secured bondholders are paid. Subordinated debentures are another step down the totem pole. Investors in these don't get paid until after holders of so-called senior debentures get their money.

Zero-coupon bonds may be secured or unsecured. They are issued at a big discount from face value because they pay all the interest at maturity, with no payments along the way. However, tax on the interest is due in the year in which it accrues, as if you had received it.

Municipal bonds are issued by state or city governments, or their agencies, and come in two principal varieties:

- General obligation bonds are backed by the full taxing authority of the government.
- Revenue bonds are backed only by the receipts from a specific source of revenue, such as a bridge or highway toll, and thus are not considered as secure as general obligation bonds.

The interest that is paid to holders of both revenue and general obligation municipal bonds is exempt from federal income taxes and, usually, income taxes of the issuing state as well.

U.S. Treasury bonds that mature in a year or less are called Treasury bills and those that mature in under ten years may be called notes. Both are backed by the full faith and credit of the federal government.

Agency securities are issues from various U.S. government-sponsored organizations, such as Fannie Mae (formerly called the Federal National Mortgage Association) and the Tennessee Valley Authority. Although they are not technically backed by the full faith and credit of the U.S. Treasury, they are widely considered to be moral obligations of the federal government, which presumably wouldn't let an agency issue fail.

U.S. savings bonds come in three varieties: EE bonds and I bonds, which are vehicles for savings, and HH bonds, which were created to produce income but are no longer being sold.

- EE bonds pay a fixed rate of interest for the 30-year life of the

bond. Interest is compounded semiannually, with a three-month interest penalty if the bond is cashed in before five years.

- I bonds are inflation-adjusted bonds. The interest paid comes in two parts: You get an underlying fixed rate, announced when the bond is issued, plus a second rate equal to the level of inflation. You must keep the bond at least one year before you redeem it and at least five years if you don't want to forfeit three months of accrued interest.

Callable bonds are issues that can be redeemed, or "called," before they mature. A company might decide to call its bonds if, for instance, interest rates fell so far that it could issue new bonds at a lower rate and thus save money. If the bond were called for more than you paid for it, you'd owe tax on the difference.

Convertible bonds are corporate bonds that can be swapped for the same company's common stock at a fixed ratio—a specified amount of bonds for a specified number of shares of stock. Convertible features make some companies' bonds more attractive by offering the possibility of an equity kicker: If the price of the stock rises enough after you buy the convertible bonds, you can profit by swapping your bonds for stock.

For example, suppose you buy five convertible bonds issued by Company A at $1,000 each. The bonds pay 7% and each is convertible into 40 shares of company stock. When you buy the bonds, Company A stock is selling at $20 a share. Because break-even conversion price is $25, you've paid $5 a share for the conversion privilege. If Company A's stock climbs above $25, you can make a profit by converting your bonds to stock. If the price were to go to $30, you could turn your $5,000 bond investment into $6,000 worth of stock.

Because their fate is so closely tied to that of the stock price of the issuing firm, convertible bonds tend to be more closely in sync with the stock market than the bond market.

Unlocking the Potential of Bonds

When a new bond is issued, the interest rate it pays is called the coupon rate, which is the fixed annual payment expressed as a percentage of the face value.

A 5% coupon bond pays $50 a year interest on each $1,000 of face value, a 6% coupon bond pays $60 and so forth. That's what the issuer will pay—no more, no less—for the life of the bond.

But it may or may not be the yield you can earn from that issue, and understanding why is the key to unlocking the real potential of bonds.

> The interest a bond pays is called the coupon rate, an annual payment that's a percentage of the bond's face value.

THE RELATIONSHIP BETWEEN YIELD AND PRICE.

Take a new bond with a coupon interest rate of 6%, meaning it pays $60 a year for every $1,000 of face value. What happens if interest rates rise to 7% after the bond is issued? New bonds will have to pay a 7% coupon rate or no one will buy them. By the same token, you could sell your 6% bond only if you offered it at a price that produced a 7% yield for the buyer. So the price at which you could sell would be whatever $60 represents 7% of, which is $857.14. Thus, you'd lose $142.86 if you

sell. Even if you don't sell, you suffer a paper loss because your bond is now worth $142.86 less than you paid for it. It is selling at a discount.

But what if interest rates were to decline? Say rates drop to 5% while you're holding your 6% bond. New bonds would be paying only 5% and you could sell your old bond for whatever $60 represents 5% of. Because $60 is 5% of $1,200, selling your 6% bond when interest rates are at 5% would produce a $200 capital gain. That $200 is called a premium.

Actual prices are also affected by the length of time left before the bond matures and by the likelihood that the issue will be called. But the underlying principle is the same, and it is the single most important thing to remember about the relationship between the market value of the bonds you hold and changes in current interest rates:

As interest rates rise, bond prices fall; as interest rates fall, bond prices rise. The further away the bond's maturity or call date, the more volatile its price tends to be.

As interest rates rise, bond prices fall; as interest rates fall, bond prices rise.

VARIETIES OF YIELD.

Because of this relationship, the actual yield to an investor depends in large part on where interest rates stand the day the bond is purchased, so the vocabulary of the bond market needs more than one definition for yield.

Coupon yield, the annual payment expressed as a percentage of the bond's face value, is only one way to look at a bond's payout. These are the others:

Current yield is the annual interest payment calculated as a percentage of the bond's current market price. A 5% coupon bond selling for $900 has a current yield of 5.6%, which is figured by taking the $50 in annual interest, dividing it by the $900 market price and multiplying the result by 100.

Yield to maturity includes the current yield and the capital gain or loss you can expect if you hold the bond to maturity. If you pay $900 for a 5% coupon bond with a face value of $1,000 maturing five years from the date of purchase, you will earn not only $50 a year in interest but also another $100 when the bond's issuer pays off the principal. By the same token, if you buy that bond for $1,100, representing a $100 premium, you will lose $100 at maturity.

HOW TO REDUCE THE RISKS IN BONDS.

Interest-rate changes create one of the chief risks you face as an investor in bonds. The market value of the bonds you own will decline if interest rates rise.

This unalterable relationship suggests the first of several risk-reducing steps you can take as a bond investor:

- **Don't buy bonds when interest rates are low or rising.** The ideal time to buy bonds is when interest rates have stabilized at a relatively high level or when they seem about to head down.

- **Stick to short- and intermediate-term issues.** Maturities of three to five years will reduce the potential volatility of your bond holdings. They fluctuate less in price than longer-term issues, and they don't require you to tie up your money for ten or more years in exchange for a relatively small additional yield.

- **Acquire bonds with different maturity dates** to diversify your bond holdings. A mix of issues maturing in one, three and five years will help to protect you from getting hurt by interest rate movements you can't control. Bond mutual funds are a good way to achieve diversity in your bond investments.

LIMIT DEFAULT RISK.

Interest-rate rises aren't the only potential enemy of bond investors. Another risk to consider is the chance that the organization that issued the bonds won't be able to pay them off. It's not realistic to expect that you could do the kind of balance-sheet analysis it takes to size up a company's ability to pay off its bonds in ten, 20 or even 30 years. Assessing the creditworthiness of companies and government agencies issuing bonds is a job for the pros, the best known of which are Standard & Poor's (S&P) and Moody's. If the issuer earns one of the top four "investment grades" assigned by the companies—AAA, AA, A or BBB from Standard & Poor's, and Aaa, Aa, A or Baa from Moody's—the risk of default is considered slight. The box below gives a detailed breakdown of the companies' rating systems for issues considered to be worthy of the investment-grade designation. (Sometimes the ratings will be supplemented by a "+" or a "-" sign.)

Ratings below investment grade indicate that the bonds are considered either "speculative" (BB, Ba or B) or in real danger of default (various levels of C and, in the S&P ratings, a D, indicating that the issue is actually in default). You can consider any issue rated speculative or lower to be a "junk" bond, although brokers and mutual funds usually call them "high-yield" issues.

Individual junk bonds are very risky; it's best to avoid them unless you're willing to study the company's prospects closely. Alternatively, you could purchase shares in a junk bond mutual fund, which would ease the risk a bit through diversification. Even then, junk bonds should never occupy more than a sliver of your portfolio.

Check the rating of any bond you're considering purchasing. A broker can give you the rating, or you can look it up in the Moody's or S&P bond guides found in many libraries. Online sources for ratings include S&P (www.standardandpoors.com) and Bondsonline.com. Moody's has a Web site, too (www.moodys.com), although you may find it difficult to search for ratings of individual companies.

WHAT THE RATINGS MEAN

S&P	Moody's	What it Means
AAA	Aaa	The highest possible rating, indicating the agencies' highest degree of confidence in the issuer's ability to pay interest and repay the principal.
AA	Aa	A very high rating, only marginally weaker than the highest.
A	A	High capacity to repay debt but slightly more vulnerability to adverse economic developments.
BBB	Baa	The lowest investment-grade rating, indicating "adequate" capacity to pay principal and interest but more vulnerability to adverse economic developments.

For a mutual fund, the prospectus will describe the lowest rating acceptable to the fund's managers, and the annual reports should list the bonds in the fund's portfolio, along with their ratings.

In general, the lower the rating, the higher the yield a bond must offer to compensate for the risk.

Diversify bond holdings across several different issuers, whether corporate or municipal. The fact that a municipal or corporate bond has a high rating is no guarantee that it is completely safe. Bonds issued by the federal government are the only exceptions to this rule. They are as safe as you're going to get.

One way to diversify your bond investments is to buy shares in bond mutual funds.

Pay attention to the news. The rating agencies do a good job of tracking the issues they've rated, raising or lowering ratings when they think a change is justified. Hundreds of "fallen angels" get downgraded each year, and hundreds get upgraded. The last thing you want is to have the rating of a bond issue lowered while you're holding it in your portfolio. Even a slight downgrade can affect a bond's value. To guard against downgrading, you have to pay attention to the company's prospects after you buy the bond.

Consider other factors. Ratings aren't the final word on good bond buys. In fact, the market often recognizes problems with bond issues before the rating services can react.

Consider a bond's rating in the context of other information about bond issues you might buy:

- **Compare the bond's price and yield** with those of bonds with identical ratings to see which is the better buy.
- **Make sure you're looking at the bonds' current credit rating.** Buying on the basis of an outdated rating can be an expensive mistake.
- **Make sure there's a market for the bond.** This advice sounds obvious, but one thing that can cause junk bonds to lose so much of their value so fast is a situation in which there are suddenly many, many sellers and very few buyers, as when bad news hits.

Protect Your Money: How to Check Out a Broker or Adviser

Federal or state securities laws require brokers, advisers, and their firms to be licensed or registered, and to make important information public. But it's up to you to find that information and use it to protect your investment dollars. The good news is that this information is easy to obtain, and one phone call or web search may save you from sending your money to a con artist, a bad broker, or disreputable firm.

This is very important, because if you do business with an unlicensed securities broker or a firm that later goes out of business, there may be no way for you to recover your money — even if an arbitrator or court rules in your favor.

BROKERS AND BROKERAGE FIRMS.

The Central Registration Depository (or "CRD") is a computerized database that contains information about most brokers, their representatives, and the firms they work for. For instance, you can find out if brokers are properly licensed in your state and if they have had run-ins with regulators or received serious complaints from investors. You'll also find information about the brokers' educational backgrounds and where they've worked before their current jobs.

You can ask either your State Securities Regulator or NASD to provide you with information from the CRD. Your State Securities Regulator may provide more information from the CRD than NASD, especially when it comes to investor complaints, so you may want to check with them first. You'll find contact information for your State Securities Regulator on the North American Securities Administrators Association (NASAA) Web site (www.nasaa.org). To contact NASD, go online to www.nasd.com, or call 800- 289-9999.

INVESTMENT ADVISERS.

People or firms that get paid to give advice about investing in securities must register with either the U.S. Securities and Exchange Commission (SEC) or the State Securities Regulator where they have their principal place of business. Investment advisers who manage $25 million or more in client assets generally must register with the SEC. If they manage less than $25 million, they generally must register with the State Securities Regulator.

Investment advisers must register with either the SEC or State Securities Regulator where they do business.

Some investment advisers employ investment adviser representatives, the people who actually work with clients. In most cases, these people must be licensed or registered with your State Securities Regulator to do business with you. So be sure to check them out.

To find out about advisers and whether they are properly registered, read their registration forms, called the "Form ADV," which has two parts. Part 1 has information about the adviser's business and whether they've had problems with regulators or clients. Part 2 outlines the adviser's services, fees and strategies. Before you hire an investment adviser, always ask for and carefully read both parts of the ADV.

You can view an adviser's most recent Form ADV online at www.adviserinfo.sec.gov. The database contains Forms ADV only for investment adviser firms that register electronically using the Investment Adviser Registration Depository, but will expand to encompass all registered investment advisers—individuals as well as firms.

You can also get copies of Form ADV for individual advisers and firms from the investment adviser, your State Securities Regulator (page 8), or the SEC, depending on the size of the adviser. To contact your State Securities Regulator go online to www.nasaa.org. If the SEC registers the investment adviser, you can get the Form ADV for $ .24 per page (plus postage) from the SEC.

WRAP UP.

Bonds and bond mutual funds offer diversity to your your portfolio, a sound balance to stocks and stock funds, in part because as interest rates rise and stocks tend to slow or decline in value, bonds tend to increase in value. The relative safety of many bonds compared to stocks make them an increasingly important part of your portfolio as you near and enter retirement. And different types of bonds offer a variety of risk choices, from high-risk speculative "junk" bonds to no-risk U.S. government Treasuries.

STATE SECURITIES REGULATORS

State Securities Regulators have protected investors from fraud for nearly 100 years. Securities markets are global but securities are sold locally by professionals who are licensed in every state where they conduct business. State Securities Regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

Your State Securities Regulator can:

- Verify a broker-dealer or investment adviser is properly licensed;
- Provide information about: prior run-ins with regulators that led to disciplinary or enforcement actions; serious complaints that may have been lodged against them; their educational background and prior work history
- Provide a computer link or telephone number or address where you can file a complaint; and
- Provide non-commercial investor education and protection materials.

For contact information for your State Securities Regulator, visit the North American Securities Administrators Association (NASAA) Web site at www.nasaa.org and click on "Contact Your Regulator."

GLOSSARY

Accrued interest— Interest that is due, on a bond for example, but that hasn't yet been paid.

Bond— An interest-bearing security that obligates the issuer to pay a specified amount of interest for a specified time, usually several years, and then repay the bondholder the face amount of the bond.

Bond rating— A judgment about the ability of a bond issuer to fulfill its obligation to pay interest and repay the principal when it is due.

Call— The ability of a bond issuer to redeem a bond before its maturity date.

Capital gain (loss)— The difference between the price at which you buy an investment and the price at which you sell it.

Coupon rate— A way of expressing bond yield, this is the fixed annual interest payment expressed as a percentage of the face value of the bond. A 9% coupon bond, for example, pays $90 interest a year on each $1,000 of face value.

Face value— The amount an issuer pays to a bond holder when the bond reaches full maturity.

Maturity— The amount of time it takes for a bond to pay the face value. Bonds are issued with varying maturity dates.

Mutual Fund— A professionally managed portfolio of stocks and bonds or other investments divided up into shares.

Prospectus— A document that describes a securities offering or the operations of a mutual fund.

Risk— The possibility that you may lose some (or all) of your original investment. In general, the greater the potential gain from an investment, the greater the risk is that you might lose money.

Secondary market— The general name given to marketplaces where stocks, bonds, mortgages and other investments are sold after they have been issued and sold initially.

Stock— A share of stock that represents ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future.

Yield— In general, the annual cash return earned by a stock, bond, mutual fund or other investment. Bond yields can take many forms. Coupon yield is the interest rate paid on the face value of the bond. Current yield is the interest rate based on the actual purchase price of the bond, which can be higher or lower than the face value. Yield to maturity is the rate that takes into account the current yield and the face value, with the difference assumed to be amortized over the remaining life of the bond.

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine, the Investor Protection Trust and the American Library Association are available at your library.

FIVE KEYS TO INVESTING SUCCESS

- Make investing a habit
- Set exciting goals
- Don't take unnecessary risks
- Keep time on your side
- Diversify

THE BASICS FOR INVESTING IN STOCKS

- What is a stock?
- Types of stocks and their relative risks
- How to buy stocks
- Stock terms you need to know, such as price/earnings ratio (P/E), book value, dividend yield and dollar-cost averaging
- Selling your stocks and determining earnings
- Mistakes even seasoned investors sometimes make—and how to avoid them

A PRIMER FOR INVESTING IN BONDS

- What is a bond?
- How bonds work
- Types of bonds and their relative safety
- Why bonds can be an important part of your investment portfolio
- Yield and how it relates to bond prices
- Bond ratings and how they can help you reduce risk

MUTUAL FUNDS: MAYBE ALL YOU'LL EVER NEED

- What is a mutual fund?
- Advantages of investing in mutual funds
- Cost of investing in mutual funds
- Find the right mutual funds for you
- What to look for in a mutual fund prospectus
- Types of mutual funds and relative risk
- Determining your earnings

GETTING HELP WITH YOUR INVESTMENTS

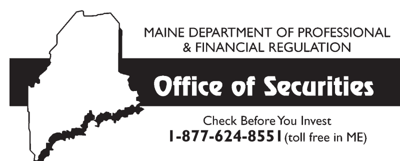
- Choosing a broker
- Full-service, discount and online brokers
- Opening a brokerage account
- Records you need to keep
- Problems with your broker
- Financial advisers
- How to choose an adviser
- Investment clubs

WHERE TO INVEST YOUR COLLEGE MONEY

- Creating a college fund portfolio based on your time horizon
- College investment vehicles
- State-sponsored college savings plans

MAXIMIZE YOUR RETIREMENT INVESTMENTS

- Three fundamental truths about retirement investing
- Stocks, bonds and mutual funds to consider for your retirement portfolio
- Determining your portfolio mix, depending on your time horizon and risk tolerance
- Retirement investment vehicles



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