

Investing: Bonds

Judith R. Urich,
Ph.D., CFP
Extension Family
Resource Management
Specialist

Bonds are **debt certificates**. The issuer of bonds (the borrower) promises to repay the bond holder in full at a designated maturity date. For the use of his or her money, the bond holder receives a fixed amount of income, called **interest**. Since the interest rate never changes, bonds are called **fixed income securities**.

Borrowers include the federal or state government, municipalities or corporations. They issue bonds to meet certain financial needs. Bond holders may be individuals, mutual funds or certain types of corporations such as insurance companies.

Better quality bonds offer a high degree of safety. The stability of both principal (the money invested) and interest are two desirable investment features of bonds when they are held to maturity.

Bond Characteristics

Bonds are issued at what is called the **face value** or **par value**. This value, which is stated on the bond certificate, is usually \$1,000, but it may be \$5,000, \$10,000 or more.

After a bond is issued, however, its value does not necessarily stay at par. The price of a bond at a particular time will depend on what investors are willing to pay in the marketplace. The price will depend on the general money market situation and interest rates offered on other financial products.

Bonds can be purchased or sold:

- At par value
- At a discount (below par value)
- At a premium (above par value)

Bonds sell at a **discount** when the current price is lower than the par value. For example, the bond may sell for \$850 while its par value is \$1,000.

But at the maturity date, the total par value will be paid out to you – no more, no less. Bond purchasers who want both safety and income are advised to buy bonds with the intention of holding them to maturity.

The **interest rate** on bonds is predetermined. It is set at a fixed rate on the date the bond is issued. For example, if you purchase a 9 percent bond, the issuer will pay annual interest of 9 percent on the par value of the bond until it matures. On a \$1,000 bond, that would mean an annual income of \$90.

But suppose you purchased this bond after it was issued and when it was selling at a discount. If the price you paid for the \$1,000 bond was only \$900, your effective annual return on the investment would be 10 percent, not 9 percent. Moreover, you would have a capital gain of \$100 when the bond reached maturity. Thus, the **yield to maturity** would be even larger than the 10 percent current yield on the investment.

*Arkansas Is
Our Campus*

Visit our web site at:
<http://www.uaex.edu>

Bond Types

Several types of bonds can be identified, depending on who issues them. The most common are U.S. government securities, municipal bonds, corporate bonds and utility bonds.

Investments in **U.S. government securities** carry the full backing and prestige of the U.S. government. There is virtually no chance of default. Maturity periods vary. **Treasury Bonds** have the longest maturity period – from 10 to 30 years. **Treasury Notes** mature in 2 to 10 years. **Treasury Bills** are issued for shorter maturities – 3, 6, 9 or 12 months.

Several federal agencies, such as the Farm Credit System, also issue bonds to meet their money needs. These bonds are nearly as secure as U.S. government securities and often will pay slightly higher interest.

Municipal bonds are debt obligations of state and local governments. Funds generated by these bonds are used to finance construction or repair of highways, hospitals, schools or other public facilities. Interest earned from municipal bonds is exempt from federal income taxes and from state and local income taxes in the state in which they were issued. Municipal bonds will typically carry a lower interest rate than other bonds, but investors in higher income tax brackets may still find the municipals attractive.

Opportunities to buy and sell some municipal bonds are restricted if few bonds were sold for a small project in a limited geographic area. Consider buying well-known issues of larger state and local governments if you anticipate selling the bonds prior to maturity.

Corporate bonds are debt obligations of corporations. They carry a higher interest rate than other bonds and are often issued for longer periods of time – 30 years is common. Quality of corporate bonds varies greatly. There is usually a trade off between quality and interest earned that has to be evaluated by investors.

Utility bonds are offered by such utilities as gas, electric and telephone companies. They vary in quality and yields.

How to Buy

Bonds are bought and sold through stock brokers. U.S. government securities may also be bought through commercial banks. Both brokerage firms and banks charge a commission for the service. Treasuries (bonds, notes and bills) can be bought at no charge through Treasury Direct system, by phone (800) 943-6864, mail Treasury Direct, P.O. Box 9150, Minneapolis, MN 55480-9150 or through the Internet www.publicdebt.treas.gov.

Points to Consider

Four factors to consider when buying bonds are:

1. **Quality** ratings of corporate, utility and many municipal bonds are determined by two investment advisory services – Standard and Poor's Corporation and Moody's Investor Service. Risk of loss of principal ranges from very little to considerable. Before investing, consult a financial expert or one of these advisory services to determine the quality of the issue.
2. The **yield** is important – before and after taxes. The "formula" for high bond yields is a combination of tight monetary conditions, low quality and longer maturities. Many investors prefer corporate bonds to U.S. government securities because the former often have a higher yield. But treasury bonds, notes and bills are taxable only at the federal level, and municipal bonds may not be taxed at all.
3. The **maturity** date of bonds is significant during periods of high inflation. Since the par value of a bond does not change from issuance to maturity, the **real** value declines as the purchasing power of each dollar drops.
4. The **price** of bonds fluctuates in response to interest rates and maturity dates. The higher interest rates go, the lower bond prices will be. And the more time until the bond matures, the greater the price fluctuations as bond yields (interest rates) shift up and down.

Credit is given to A. L. (Roy) Frederick, Extension agricultural economist, Cooperative Extension Service, Kansas State University, for information in this publication.

DR. JUDITH R. URICH, Extension family resource management specialist, is a Certified Financial Planner licensee and is located at the Cooperative Extension Service, University of Arkansas, Little Rock.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Director, Cooperative Extension Service, University of Arkansas. The Arkansas Cooperative Extension Service offers its programs to all eligible persons regardless of race, color, national origin, religion, gender, age, disability, marital or veteran status, or any other legally protected status, and is an Equal Opportunity Employer.