Investing In Bonds

Bonds are actually loans that investors -- individuals like you, as well as institutions -- make to the federal government, state governments, municipalities, companies, and government agencies. Investors who buy bonds become bondholders, or lenders. Bondholders get an "I.O.U." from the issuer of the bond, but the bondholder doesn't have any ownership rights like stockholders do. Generally, bonds are fixed-income securities because they pay you, as the bondholder, a predetermined interest rate (also called "coupon rate"), regularly, that is set when the bond is issued. However, some bonds are issued with variable rates that can be affected by external economic factors. The borrower or issuer promises to pay back the loan in full on the maturity date. All bonds have set maturity dates--the date when it must be paid back to investors at its face amount, called "par value."

Bonds are usually sold in $1,000 units. Like its interest rate, a fixed-income bond's term is set when it is issued. Short-term bonds are usually one year or less. Intermediate-term bonds run 2 to 10 years and long-term bonds are generally for at least 20 to 40 years. In most cases, the longer the term, the higher the interest rate paid. Just as bank certificates of deposit (CDs) pay higher interest rates for the right to keep your money for a longer term than an ordinary savings account, so do bonds. Be aware, however, that the risk level increases the longer the bond is held because of its vulnerability to interest rate fluctuations and inflation, over time.

Different Types of Bonds

Private corporations issue corporate bonds to raise money for capital expenditures, operations, and acquisitions. Corporate bond interest is taxable and the prices are well publicized (usually in newspapers), so it's easy to know what the bonds are worth. As with stocks, investing in corporate bonds carries risk. The value of the bond may change depending on changes in the company's credit rating and, in the event of a corporate bankruptcy, holders of corporate bonds suffer significant losses.

U.S. Treasury bonds are long-term debt instruments that pay for various government operations and are applied toward the national debt. Unlike stock and corporate bonds, Treasury bonds are backed by the full faith and credit of the U.S. government, which means that the resources of the United States would make sure that your investment was repaid, making them relatively secure investments.

Municipal bonds issued by states, cities, counties, and towns pay for public works projects like new schools and highways. Your investment in municipal bonds is generally exempt from federal income taxes, and in many states, from state income taxes, too. This may be advantageous if you are in a high tax bracket. A tax-free bond usually has a lower yield than a taxable bond. You can determine your net (after tax) yield from a taxable bond by subtracting the amount of yield from your marginal tax rate. (Your marginal tax rate is based on your filing status).

Secured bonds are backed by collateral that the issuer may sell to repay you if the bond is defaulted on at maturity. Unsecured bonds, called debentures, are backed by the promise and good credit of the bond's issuer. A convertible bond may at some time be exchanged for other securities from the issuing company under specified conditions.

Understanding Your Bond Investment

Interest rates affect bond prices--though, inversely. Usually, bond prices move in the opposite direction of national interest rates; when interest rates rise, bond prices fall. For example: you buy a 10-year, $1,000 bond issued at 7 percent today. Five years later, you want to sell that bond, but now interest rates have risen to 9 percent and new bonds are paying 9 percent. Few people

would want to buy a $1,000 bond paying only 7 percent. So, you would probably have to sell that $1,000 bond for less than $1,000 to make up for the higher interest rate now being paid on other bonds.

Bond Quotes

Bond price quotations use eighths, but with a difference. Bonds are sold in units of $1,000 but are quoted as 100s. To find the correct dollar value, move the decimal one place to the right.
For example, a bond quoted at 98 1/4 is equivalent to 98.25. Move the decimal one place the right to find the dollar price of the bond, which is $982.50. This bond is selling for less than $1,000 so it is selling at a discount, probably because of a low rate of interest. A bond quoted at 102 3/8 (102.375) equals $1,023.75. This bond is selling at a premium, probably because of a high interest rate or yield.

Bond Rating Codes		
Rating	**S&P**	**Moody's**
Highest quality	AAA	Aaa
High quality	AA	Aa
Upper medium quality	A	A
Medium grade	BBB	Baa
Somewhat speculative	BB	Ba
Low grade, speculative	B	B
Low grade, default possible	CCC	Caa
Low grade, partial recovery possible	CC	Ca
Default, recovery unlikely	C	C

Bond ratings measure credit risk. Several private agencies, such as Moody's and Standard & Poor's, rate bonds based on their assessment of underlying risk that the issuer may not be able to pay back the bond's principle and interest. The better the rating, the lower the interest the bond will usually pay. Generally the higher the yield, the greater the risk. **Remember:** in extreme cases, the issuer of the bond can suspend interest payments or default entirely. Issuers can also buy back, or "call," the bonds before maturity if interest rates fall. You should study the call provisions thoroughly before buying a bond.

Finally, some bonds, like U.S. Treasuries and municipals bonds, require large minimum investments, usually $10,000.

Bond Quotations				
1	**2**	**3**	**4**	**5**
Bonds	**Cur. Yld.**	**Vol.**	**Close**	**Net Change**
Chiquita 10 1/2 04	10.7	144	98 1/4	+ 3/8
K Mart 6.2s17	cv	50	91	+ 1/4
Disney zr05	...	414	45 3/4	+ 3/4

What It Says:

Column 1
Bond, Coupon Rate,
Date of Maturity
A bond issued by Chiquita which matures in 2004 has a coupon rate of 10 1/2. This stated annual interest rate represents the 10.5 percent paid on the bond's $1,000 face value. The holder of this bond will receive $105 annually.

The "s" in the K Mart quotation separates the 6.2 percent rate from the 2017 maturity date. Note this bond is listed in fractions of 10s instead of 8s.

The Disney bonds are zero coupon bonds as indicated by the "zr." They do not pay annual interest.

Column 2
Current Yield
At this day's price, the holder of a Chiquita bond annually will receive 10.7 percent or $10.70 for every $100 invested. The current yield is calculated by dividing the annual interest by the closing price. "cv" indicates the K Mart bond is convertible and can be exchanged for K Mart stock.

Column 3
Volume
On this day, 500,000 K Mart bonds were sold. The number 50 has been multiplied by 10,000.

Column 4, 5
The final price for Chiquita bonds was $982.50 which was $3.75 more than the final price on the day before.