Bond Basics

Have you ever borrowed money? Of course you have! Whether we hit our parents up for a few bucks to buy candy as children or asked the bank for a mortgage, most of us have borrowed money at some point in our lives.

Just as people need money, so do companies and governments. A company needs funds to expand into new markets, while governments need money for everything from infrastructure to social programs. The problem large organizations run into is that they typically need far more money than the average bank can provide. The solution is to raise money by issuing bonds (or other debt instruments) to a public market. Thousands of investors then each lend a portion of the capital needed. Really, a bond is nothing more than a loan for which you are the lender. The organization that sells a bond is known as the issuer. You can think of a bond as an IOU given by a borrower (the issuer) to a lender (the investor).

Of course, nobody would loan his or her hard-earned money for nothing. The issuer of a bond must pay the investor something extra for the privilege of using his or her money. This "extra" comes in the form of interest payments, which are made at a predetermined rate and schedule. The interest rate is often referred to as the coupon. The date on which the issuer has to repay the amount borrowed (known as face value) is called the maturity date. Bonds are known as fixed-income securities because you know the exact amount of cash you'll get back if you hold the security until maturity.

For example, say you buy a bond with a face value of $1,000, a coupon of 8%, and a maturity of 10 years. This means you'll receive a total of $80 of interest per year for the next 10 years. Actually, because most bonds pay interest semi-annually, you'll receive two payments of $40 a year for 10 years. When the bond matures after a decade, you'll get your $1,000 back.

<u>Debt Versus Equity</u>
Bonds are debt, whereas stocks are equity. This is the important distinction between the two securities. By purchasing equity (stock) an investor becomes an owner in a corporation. Ownership comes with voting rights and the right to share in any future profits. By purchasing debt (bonds) an investor becomes a creditor to the corporation (or government). The primary advantage of being a creditor is that you have

a higher claim on assets than shareholders do: that is, in the case of bankruptcy, a bondholder will get paid before a shareholder. However, the bondholder does not share in the profits if a company does well - he or she is entitled only to the principal plus interest.

To sum up, there is generally less risk in owning bonds than in owning stocks, but this comes at the cost of a lower return.

<u>Why Bother With Bonds?</u>

It's an investing axiom that stocks return more than bonds. In the past, this has generally been true for time periods of at least 10 years or more. However, this doesn't mean you shouldn't invest in bonds. Bonds are appropriate any time you cannot tolerate the short-term volatility of the stock market. Take two situations where this may be true:

1) Retirement - The easiest example to think of is an individual living off a fixed income. A retiree simply cannot afford to lose his/her principal as income for it is required to pay the bills.

2) Shorter time horizons - Say a young executive is planning to go back for an MBA in three years. It's true that the stock market provides the opportunity for higher growth, which is why his/her retirement fund is mostly in stocks, but the executive cannot afford to take the chance of losing the money going towards his/her education. Because money is needed for a specific purpose in the relatively near future, fixed-income securities are likely the best investment.

These two examples are clear-cut, and they don't represent all investors. Most personal financial advisors advocate maintaining a diversified portfolio and changing the weightings of asset classes throughout your life. For example, in your 20s and 30s a majority of wealth should be in equities. In your 40s and 50s the percentages shift out of stocks into bonds until retirement, when a majority of your investments should be in the form of fixed income.