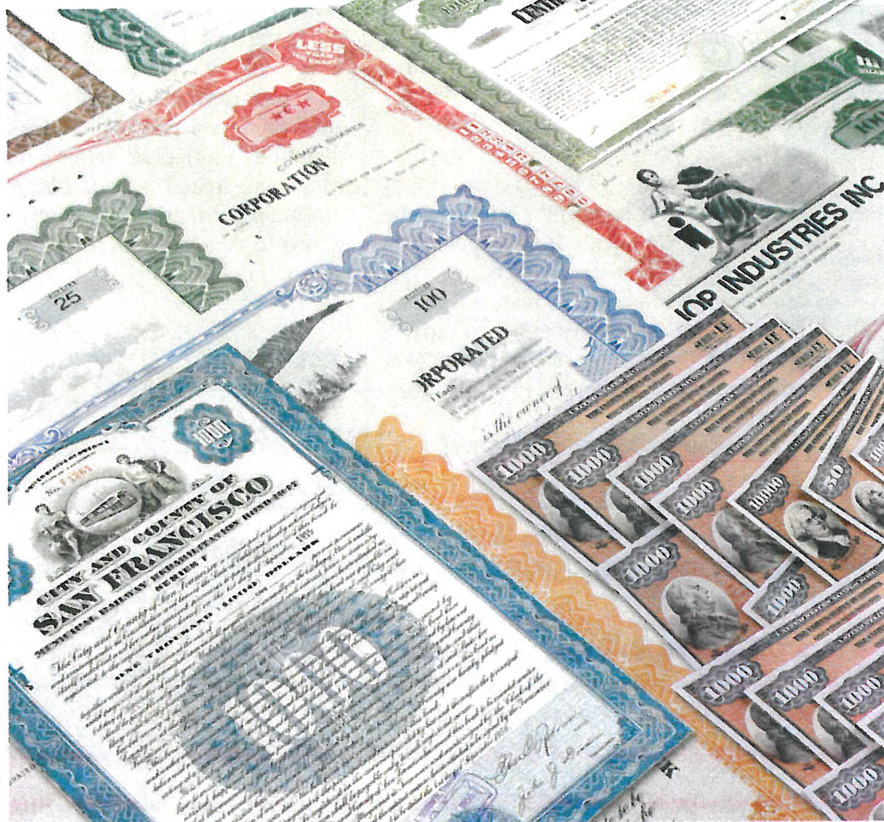
How to Explain Bonds



Knowing the key facts and primary risks regarding bonds can help you serve your clients.

By Bryce Sanders

If your prospects say, "I only buy bonds," what do you need to know in order to serve them?

What Is a Bond?

It is a security representing a loan between the borrower and investor. Bonds usually are issued in $1,000 denominations, called principal, par value or face value. Bonds are designed to return the principal at maturity, which is a set date in the future. Along the way, the investor receives interest payments at a fixed rate, usually at six-month intervals. Those payments are often called coupon interest because years ago people used to "clip coupons."

Who Buys Bonds?

Investors who seek to lock in a fixed rate of return and hold the bond until maturity. Retirees like bonds because the interest checks are similar to a paycheck and they receive the face value at maturity. Many investors use an asset allocation of stocks, bonds and cash when building their portfolios. Bonds help soften volatility because they usually don't move in lockstep (correlate) with the stock market.

Where Do Bonds Come From?

There are three broad categories: government, municipal and corporate bonds.

» **Government bonds** are issued by the federal government through the Treasury Department or various federal agencies. Treasury bonds are the primary form of government bond. They are attractive because Treasuries are backed by the full faith and credit of the U.S. government. It is assumed that the federal government can print money to pay off the bonds. Interest earned on Treasuries is not subject to state income tax but is subject to federal tax.

» **Municipal bonds** are issued at the state level. They might come directly from the state, a city or even a state agency. States cannot print money, so investors want a level of assurance they will be repaid. General Obligation bonds (GOs) are often considered the safest because they are backed by the taxing power of the state or city issuing the bonds. It is assumed that they can raise taxes as necessary to repay the bonds. Revenue bonds are often tied to a project that is run by the issuing agency. Consider a new bridge funded by a bond issue. Toll revenue collected pays the interest and the return of principal. It's like lending money to a business. Income from municipal bonds is free from federal income tax but subject to state income tax, unless the bond is issued in the investor's home state. This is why municipals are often called "tax-free bonds."

» **Corporate bonds** are issued by businesses. They may or may not be companies whose common stock trades on a stock exchange. The investor makes a loan to a business. The business promises to repay the principal at maturity. The corporation usually specifies the use they plan for the money raised, just as your bank might ask, "Why do you want this loan?" Interest earned on corporate bonds is taxable.

Why Issue Bonds?

Why not just go to a bank? Rates may be higher. The bank might limit the amount they will lend or place restrictions on the loan. The amount needed might be immense. For example, in September 2013, Verizon Communications raised $49 billion in a corporate bond sale when they bought out Vodaphone's 45 percent stake in Verizon Wireless. Selling bonds lets the issuer retain greater control. For example:

» **Call Features** – If interest rates fall, the issuer can issue another bond for a similar amount at a lower interest rate to different investors and pay the bond off early. The bond stipulates the earliest

date it can be called, often 10 years in the municipal market. In this case, the feature would be described as 10-year call protection. If the issuer intends to get out of their obligation early, they often pay a set premium. The buyer of a $1,000 bond might receive $1,020 if the bond is called early. Generally speaking, U.S. Treasury bonds are noncallable.

» **Sinking Funds** – Municipalities sometimes redeem a small percentage of the bonds annually over a long period. This substantially reduces the amount they are required to pay off at maturity. As an investor, you assume it's easier to repay a small debt than a large one. However, you are subject to a version of a reverse lottery.

What Else Do I Need to Know?

» **Who can sell bonds?** A Series 7 license is required. A Series 6 license allows you to sell a limited selection of packaged products but not the actual bonds themselves.

» **How are bonds priced?** Buying bonds on the initial offering is attractive for investors because they are usually issued in $1,000 increments (par value). The underwriting syndicate builds in a payment for the advisor placing the bonds. Assuming the buyer holds the bond to maturity, the buyer pays no extra fees, although brokerage firms might charge account fees or the client might use a fee-based account structure.

» **Do bond buyers pay other fees?** When investors buy a bond, they pay the purchase price plus accrued interest – they pay the previous owner the interest they've earned since the last interest payment. The new owner collects the next six-month payment on schedule, even if they owned the bond for only a few weeks.

» **How are bonds traded?** Almost all bonds are unlisted, meaning you can't look up a specific issue like you would look up the price of a share of common stock. Advisors sell bonds through their firm's trading department. Bonds are bought by traders at wholesale and sold to investors at retail.

» **How do bonds fluctuate?** If a bond were priced daily, it would reflect movements in the interest rates. How attractive is this "used" bond compared to a "new" bond? The longer the term (time until maturity), the wider the fluctuation. If an investor held a bond with a coupon paying 8 percent with 10 years remaining until maturity, the bond would be worth more than the par value of new bonds being issued at only 4 percent. On the other hand, a client owning a 4 percent bond would find their bond was less attractive if new bonds were being issued at 8 percent. Assuming the issuer is creditworthy, bonds gradually return to face value as the maturity date approaches.

If something goes wrong, some bonds are farther ahead in the creditor line than others.

» **Can you make money trading bonds?** If investors sell early, the bond might be worth more or less than they paid, depending on interest rates. Increasing your return through capital appreciation in addition to income earned is a strategy used by professional investors and bond funds.

» **What is duration?** A complicated concept measuring risk in a changing interest rate environment. The calculation takes into account various inputs (present value, yield, etc.) and calculates a number that is measured in years. This number is most commonly used by investors to gauge a bond or bond portfolio's interest rate sensitivity.

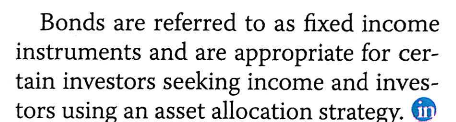
» **Are bonds safe?** Consider four risks: Duration measures interest rate risk. Credit risk relates to solvency, which is a big issue for corporate bonds. Secured bonds are backed by a specific asset. For example, airlines would secure bonds by pledging specific aircraft as collateral. If the company ran into financial difficulty, the investor knew those assets were connected to that bond. "Debentures" are unsecured bonds. All bonds are not equal. If something goes wrong, some are farther ahead in the creditor line. Reinvestment risk and inflation risk are also important.

» **How are bonds rated?** Standard & Poors, Moody's and Fitch are the most familiar rating firms. Bonds in tiers ranging from AAA to BBB are considered "investment grade." These represent the top four rungs on a 10-rung ladder.

» **How are bonds packaged?** Many people buy individual bonds and hold them until maturity. Others want monthly income. Defined Asset Funds are a basket of specific bonds structured to provide monthly income. Small fees are involved. Mutual funds and separately managed accounts use professional money managers seeking to maximize returns through capital appreciation in addition to interest income. The benefits include monthly income and the ability to reinvest those payments. The liabilities include fees paid for the structure and that monthly income is not fixed.

» **Are there exceptions to the "rules"?** Plenty. Most bonds pay a fixed rate of interest. Variable rate bonds help stabilize principal value when interest rates fluctuate. Not all bonds pay interest along the way. Zero-coupon bonds are purchased at a fraction of face value and return their par value (usually $1,000) to investors at maturity. Because their only payment comes at maturity, long-term zero-coupon bonds tend to experience more price volatility than coupon-paying bonds. Some investors find them useful when saving for a child's future college expenses.

Bonds are referred to as fixed income instruments and are appropriate for certain investors seeking income and investors using an asset allocation strategy.



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