What Is A Bond?

Imagine that you are in the ice cream store with a friend on a Thursday evening and want to get a hot fudge sundae, but you realize you don't have any cash. You know you'll be getting your paycheck the next day, so you ask your friend to lend you a few dollars so you can have the sundae now. In return for the loan, you agree to pay your friend back tomorrow and buy lunch on Saturday as well. Your friend, finding these terms to his liking, lends you the money, and you enjoy a delicious sundae.

Types of Bonds

Governments and corporations often find themselves short of cash, just as you were on Thursday. One way to generate these needed resources is to issue bonds. A bond is similar to an I.O.U. When you purchase a bond, you are lending money to a government or a corporation, known as the bond issuer. In exchange for this loan, the issuer promises to pay you a specified rate of interest during the life of the bond and to repay the original loan (referred to as the face value or par value of the bond) when it comes due at maturity.

- U.S. Government Bonds. When the U. S. government spends more than it collects in taxes, it borrows money by issuing bonds to cover the difference. The bonds issued by the U. S. government are called Treasury bonds. A special type of Treasury bond is a U.S. savings bond, which are issued in smaller amounts than other Treasury bonds. They are issued at half the face value and mature at face value at a date determined by the interest rate. Treasury bonds and U.S. savings bonds are widely regarded as the safest bond investments because they are backed by "the full faith and credit" of the U.S. government. In addition, the interest paid on U.S. government bonds cannot be taxed by state or local governments.
- Municipal Bonds. Municipal bonds are issued by states, counties, cities, towns, villages and other units of local government. These bonds are considered fairly safe but are riskier than U.S. government bonds. The risk level for a municipal bond depends on the financial condition of the state or local government that issued it. The interest paid on most municipal bonds is not taxed by the federal government.
- Corporate Bonds. As corporations grow, they often don't generate enough money to pay for the supplies necessary to keep growing. Many corporations issue bonds to pay for new capital equipment or to cover operating expenses. When a company issues bonds, it borrows money from investors in exchange for agreeing to pay them interest on their money at a set date in the future. Corporate bonds are generally riskier than government bonds because even large, stable companies are much more likely to go out of business than the U.S. government. Corporate bonds can also be the most lucrative bonds to invest in, as the investor is generally rewarded for the extra risk undertaken.

How Bonds Work

The most basic bond is called a ***coupon bond***. Coupon bonds payout an interest payment (called the coupon) to the investor every 6 months. The principal (also called the face value or par value of the bond) is paid to the investor at a specified maturity date, which can range from a few months to 30 years. These bonds are said to be fixed-income securities because the amount the investor receives is fixed by the coupon rate.

The other common bond is called a ***zero-coupon bond***. Unlike coupon bonds, zero-coupon bonds do not make periodic interest payments to the investor. Rather, investors buy the bond at a reduced face value; then, at the maturity date, investors receive one payment. The payment is equal to the principal of the bond plus the interest that has accumulated during the time the bond has been held by the investor. A U.S. savings bond is an example of a zero-coupon bond.

Why Buy a Bond?

Over the last 100 years, the stock market has provided the greatest return to investors. So why not just invest in stocks? Although they do not provide the same return as stocks in the long run, bonds have several characteristics that investors value.

- First, many bonds provide investors with relatively safe investments. Treasury bondholders can be almost certain that they will receive the amount they originally invested, plus interest, and corporate bondholders can have nearly the same certainty. By contrast, investors can lose their entire investment in individual stocks.
- Second, bonds pay interest to investors at set intervals, and this arrangement can provide valuable income for those who need a regular cash flow - retirees, for example.
- Some people buy bonds to earn capital gains. Bond prices tend to change with interest rates. When interest rates fall, bond prices rise. When interest rates rise, existing bond prices fall.
- Finally, bonds can also provide a tax advantage. When a government issues bonds to raise money to build bridges or roads, the interest investors earn can be tax-exempt. U.S. Treasury bonds are exempt from state and local taxes. Municipal bonds are exempt from federal taxes. Tax exemption can be an important factor for those who are eager to reduce the amount they pay in taxes.

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BOND QUIZ

____ 1. What is a bond's coupon?
   a. The value of a bond at its issue date
   b. The value of a bond at its maturity date
   c. The rate of interest to be paid by the bond issuer
   d. The purchase price of a bond

____ 2. A bond's face value may also be called the
   a. par value.
   b. coupon.
   c. maturity.
   d. final payment.

____ 3. Which of the following is the least risky investment?
   a. Corporate bonds
   b. Stocks
   c. U.S. Treasury bonds
   d. Mutual funds

____ 4. A bond's interest rate is called its
   a. par value.
   b. coupon rate.
   c. face value.
   d. principal.

____ 5. A zero-coupon bond pays interest
   a. periodically.
   b. at the maturity date.
   c. at the time of purchase.
   d. never.