Money matters

Investing in Bonds

If you're plotting the path to a stable financial future, you may want to consider investing some of your money in bonds. There are two good reasons to buy bonds. One, is to receive steady income that has a good chance of beating inflation. The other is to diversify your investments.

When you buy a bond, you loan money to a company or a government entity. In return, the borrower commits to paying you for the loan in two ways:

- Pay you interest, at a fixed rate, for the life of the loan, and
- Repay you the value of the loan by a certain date, known as the maturity date.

If you are thinking of buying a bond, consider some of the following questions:

- How much will you earn? To answer this question, you should learn about the different types of bonds you can buy.
- When will you be paid the interest?
- How long is the loan?
- How reliable is the borrower?
- How much do they want to borrow/invest?

To answer these questions, you should learn about the different types of bonds you can buy.

Types of Bonds

You may have heard of "junk bonds." Companies issue these, and they generally offer a high interest rate. However, they're risky, because financial analysts have doubts about the financial health of the company issuing them. If the company gets into trouble, you may not get your money back. Therefore, to achieve your goal of financial stability, you should consider investing in less risky types of bonds. These are bonds issued by either the federal government or state or local governments (known as municipal bonds), or highly rated bonds issued by companies.

Federal government bonds: Bonds issued by the Federal government are the safest. Unless the United States goes bankrupt, you're guaranteed to get your money back. Treasury bills, notes and bonds are available with maturities ranging from one to 30 years. They can easily be sold on the open market, and payment of principal and interest to you is extremely safe. But, like all bonds their values rise and fall as interest rates change; especially if the bonds have many years remaining before they mature.

Municipal bonds are issued by state and local governments to pay for things like construction projects. You pay no federal tax on earned interest, and possibly no state or local taxes, depending on whether you live in the area where the bond was issued. However, because these bonds have tax advantages, they pay lower interest rates to the owner than other types.

Corporate bonds are issued by corporations that want to raise money for things like buying new equipment or spending on new research. There's no tax exemption for these bonds.

Bond Lingo

When you look into buying bonds, you'll run into some specialized terms. They include:

- **Face value or par value:** The bond's worth at maturity. A common face value is $1,000 per bond. However, the actual market price of a bond may be higher or lower than the bond's face value.
- **Coupon rate:** The interest paid on the bond's face value. A bond with a face value of $1,000 and a 7% coupon rate pays $70 a year in interest.
- **Yield:** The annual percentage you earn on the amount you've invested.

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Risks

When you buy bonds, you're taking a risk that borrowers with poor credit ratings may not repay their loans on time, or at all. Two major services, Moody's and Standard & Poor's, rate bonds. Ratings are based primarily on the credit history and current status of the issuer. The ratings use a letter system. Bonds with only As in their rating are of high quality. Bonds with a B rating are of medium quality (except for Moody's B rating, which is below medium quality). Bonds with a C are either low or extremely low quality.

Here are three types of risks that can affect the value of bonds you buy:

- **Interest rate increases.** You won't face this risk if you hold bonds until maturity, but if you buy and sell bonds, you will. If you buy a bond and then interest rates rise, your bond loses value. This is because other investors can buy higher-rate bonds, so you would have to sell yours at a lower price to make them attractive. But, if interest rates fall, you can sell your bonds at a higher price.
- **Credit risk.** The borrower may not be able to pay the loan on time, or at all. A bond's "credit rating" gauges the issuer's credit worthiness. "Junk" bonds are issued by credit-troubled companies, so there's a high risk of default.
- **Calls.** If you buy a "callable" bond, the lender has a right to "call" the bond, meaning pay you back before the maturity date. Typically, the lender has a way to get cheaper financing—probably because interest rates have fallen. Before buying a bond, check to see if it is "callable."

Managing the Risk

Here are two ways you potentially can reduce the risks of investing in bonds:

- **Invest in Bond Funds:** A Bond mutual fund pools money from many investors. It is invested by a professional money manager, and can be made up of one type of bond or a mix. Since the investment is spread across many bonds, it's usually less risky than investing in individual bonds. To buy or sell some bond funds, you may have to pay a sales commission. There will always be an administrative fee. This fee, or "expense ratio," is subtracted from your account, which reduces your return. To avoid high fees, you can buy shares of bond "index" funds. An index fund tracks a particular market or types of bonds. Overall, index funds have performed well historically. (See AARP's tipsheet on Mutual Funds.)
- **Create a Bond Ladder:** A good way to diversify is to buy bonds with different maturity dates.

Tips: If you already own a life cycle fund or a target date fund, these may include investments in bonds. If you have a 401(k), you may be able to buy bond funds within the account. Outside of a 401(k), if you want to buy individual bonds, you'll need to use a broker, who receives a commission when you buy and sell. The Internet makes comparing brokers' fees fairly easy. To buy Treasury bonds, you can purchase them directly from the federal government.

Your To-Do List:

- ☐ **Get an overview of how bonds and bond index funds work** at www.aarp.org/finance and http://investopedia.com/university.
- ☐ **See how bonds fit into your investment and retirement strategies, compare bond interest rates, and learn about bond "laddering"** at http://apps.nasd.com/investor%5FInformation/smart/bonds/501000.asp.
- ☐ **Find out more about bonds** at http://money.cnn.com and http://moneycentral.msn.com/home.asp.
- ☐ **Before you buy a mutual fund**, add up the fees using the Securities and Exchange Commission's mutual fund cost calculator, under Investor Calculators at www.sec.gov.

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