Investing in Bonds

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01 | Different Types of Bonds

Bonds are a core component of any investor's portfolio. Generally known as the 'safest' way to invest, bonds offer stability and long-term growth to investors. Interested? Our in-depth articles will help you learn more.

Introduction

Bonds are fixed-income securities or debt instruments. When you purchase a bond, you are giving out a loan to the bond's issuer, who pays you interest for the use of your money. Bonds constitute a popular method of long-term investment, with a guarantee for maximum returns with minimum risks in the future.

Bonds are different from stocks –as they are sold by corporations, the government or its sponsored agencies, cities, states, and other public authorities. Bonds also come in several categories – from short-term notes to bonds that take 20 to 30 years to mature.

Different Types of Bonds

Almost all of these bonds in the U.S. fall into one of three categories, based on the risk factor involved.

High Risk These are rather high-risk bonds, sold by corporations, cities, and states. Those bonds are called Below-Investment-Grade, or Junk Bonds.

Medium Risk These are the low-risk bonds sold by corporations, cities, and states; these are known as "Investment Grade.

Low Risk This category consists of the extremely safe debt of the federal government and its agencies. Ex. Treasury Bonds and US Government Bonds.

Treasury Bonds

Treasury bonds are U.S. government debt securities. They have a maturity range between 10 and 30 years and a fixed interest rate. They pay semiannual interest payments until maturity, at which point the face value of the bond is paid to the owner. Such bonds are generally included in the portfolio to reduce portfolio risk. The interest payments on these bonds are exempt from both state and federal taxation. The return on most T-bonds is tied to the 5-year Treasury rate. Young investors gain from Treasury Bonds, depending on their age at the time of buying them.

U.S. Government Bonds

These include the US Government Savings Bonds, and Agency bonds issued by federal agencies, like Fannie Mae or the Federal National Mortgage Association and Ginnie Mae from the Government National Mortgage Association. They promise a guaranteed fixed rate of return adjustment for inflation.

Investment-Grade Corporate Bonds

These are the High-grade Bonds that receive higher ratings by the credit rating agencies, like bonds rated BAA (by Moody's) or BBB (by Standard & Poor and Fitch) or above. These bonds tend to be issued at lower yields than other bonds. These bonds have a lower defaulting risk. They are from companies with higher repayment capabilities.

Junk Bonds

These are the bonds that have been given lower Credit ratings like "BB," "B," "CCC," etc. by the credit rating agencies. They come under the Low Credit Quality category. Companies with these ratings fall under the "speculative grade". They are more prone to changing economic conditions.

Foreign Bonds

A foreign bond is a bond issued in the domestic market by a foreign company or organization, as a means of raising capital. This bond is issued in the domestic market's currency. Ex. Bulldog Bond in the UK, Samurai bond in Japan, and Kangaroo Bond in Australia. Foreign bonds have higher yields than domestic bonds. They involve greater risks and face repayment risk. You can add foreign content to your investment portfolios with these bonds, without the added exchange rate exposure.

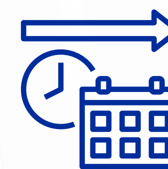
Municipal Bonds

These bonds are also known as "munis". They are issued by the U.S. states and local governments or their agencies. They come in both investment-grade and high-yield bond varieties. They are generally used to finance public projects such as roads, schools, airports, etc. The interest on these bonds is tax-free. Taxable yields are higher than muni yields to compensate investors for the taxes.

Mortgage-backed bonds

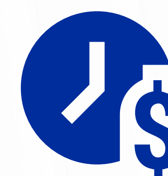
A mortgage bond is a bond secured by a mortgage or group of mortgages. These bonds are backed by real estate holdings. In case of default, mortgage bondholders have a claim to the underlying property and could sell it off to compensate. Mortgage bonds are safer than corporate bonds. They have a lower rate of return. Mortgage bonds offer investor protection because the principal is secured by a mortgage.

02 | Long-Term Bonds and Short-Term Bonds



Long Term Bonds

The bonds which are offered for a long period, typically equal to 10 or more years, come under the category of Long-Term bonds. Long term bonds offer greater yields over time, but at the same time offer more risk potential.



Short Term Bonds

The bonds which are offered for a short time, typically for a tenure below five years, come under the category of Short-Term bonds. Short term bonds offer lesser yields in their tenure, but at the same time offer less risk potential.

A particular investor's portfolio will consist of three basic types of bonds based on the average maturities of the bonds:

- Short-term-less than 5 years
- Intermediate-5 to 10 years term
- Long-term-more than 10 years term

Depending upon their tenure and market conditions, Short-term bonds have low risk and low yields, while longer-term bonds offer higher yields and also greater risk. Intermediate-term bonds fall in the middle of these two categories as far as risk and yields are concerned.

03 How to invest in bonds based upon interest rate risks?

Bonds form an important part of your investment portfolio. All bonds are not equal in the opportunities that they provide. The investors, therefore, need some strategies for investing in bonds, so that they can build up the right bond allocation.

Bonds provide regular income to investors. Their prices generally don't fluctuate too much relative to stocks. This ensures a more stable income. Investors generally invest in bonds based upon the risk factor involved and the time of maturity.

An investor for whom safety is the top priority would like to invest in short-term bonds. These short-term bonds provide some yield in exchange for greater stability and lower risk of loss. This suits the requirements for a safe investor. On the other hand, investors who can tolerate higher risk and are willing to invest their principal sums for more time can invest in long-term bonds. They can take on more risk in exchange for the higher yields in the case of these long term bonds.

Similarly, an investor who has the urgency to use the principal within three years or less should go for the less volatile short-term bonds. Investors must examine high-yield bonds carefully before investment to reduce interest rate risks. They can reduce the risks in two ways:

- You can buy a bond exchange-traded fund diversified by the issuer, to reduce the risk of an issuer not paying back a bond. This protects any one issuer.
- You can buy a bond ETF diversified by maturity, to reduce the risk of rising interest rates. This helps to limit the damage or risk caused by rising rates on your bonds.

04 What is the 10-year Treasury Bond?

Like all other debt instruments, the 10-year Treasury Bond is a loan you make to the U.S. federal government. This bond is backed by the guarantee of the U.S. economy and has a maturity time period of a decade or 10 years. It is thus a highly reliable, long-term bond, with less chance of default by the issuer. The U.S Department of the Treasury auctions the 10-year Treasury Bond note.

Key takeaways of the 10-year Treasury Bond

A treasury bond is a certificate representing a loan to the US federal government that matures in more than 10 years.

They fall under the category of the US Government debt securities like Treasury bonds, U.S. Treasury notes, Treasury securities, and government bonds.

They are seen as one of the safest investments as they are backed by the Government.

The bond prices of the Treasury Bonds and their yields follow opposite movements.

This means that when prices fall, the yields increase and vice versa.

The 10-year Treasury Bond is an economic indicator of the market status.

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