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Evaluating Bonds: An Introduction

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Bonds: knowing what to expect

Evaluating a bond purchase is very different from researching an individual stock. However, there are just as many factors to consider. Many bond investors rely on the regular income that interest paid by bonds can provide. If you're one of these investors, it's especially important to understand just what to expect from any bond you buy.

Note: *The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.*

Individual bonds vs. bond funds

One of the first decisions you'll need to make is whether to buy individual bonds or bond funds. Because they invest in many different bonds, mutual funds and exchange-traded funds (ETFs) provide greater diversification than many people can achieve on their own, and they can help cushion you against the impact of potential default by an individual bond issuer. However, a bond fund's expenses, such as management fees, can add up over time, and if the fund is actively managed, you could owe capital gains taxes as a result of the fund's trading. Individual bonds also have advantages. For instance, you may want to be certain that your principal will be returned to you by a certain date. If you hold the bond until it matures, and assuming the issuer doesn't default, an individual bond can provide that certainty. Further, with bonds that have a fixed interest rate, you know the exact amount of each interest payment you'll receive.

Caution: *Before investing in a mutual fund or ETF, carefully consider its investment objectives, risk, fees, and expenses, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing. There are several varieties of bond funds, whose mix of bonds depends on each fund's focus and stated objectives. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.*

Hold to maturity or trade?

If you hold a bond until it matures and the issuer doesn't default on it, you know what you'll receive: the interest owed on the bond from the date of purchase plus the principal. However, if you sell it before maturity, your return is less certain. You may not get the price you paid for it, or, you could profit if bond prices rise and you're able to sell your bond for more than you paid for it.

If you want to hold a bond to maturity, check to see if it has call protection that would prevent the issuer from repaying the bond early, ending your income from it. Also, be realistic about whether you'll be able to hold a 20- or 30-year bond to maturity. Remember, the longer the term of the bond, the greater the risk that you might have to sell it prematurely, even if the bond is worth less than you paid for it.

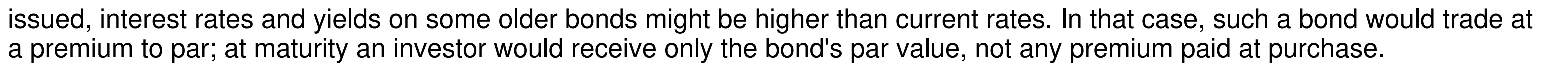
Taxable or tax-free?

A tax-free bond with a lower coupon rate might provide a better after-tax return than a taxable bond. The choice between taxable and tax-free bonds depends largely on your income tax bracket.

Note: *Interest paid by municipal bonds issued by your state or local government is typically free of federal income tax. If a bond was issued by a municipality outside the state in which you reside, the interest could be subject to state and local income taxes. If you sell a municipal bond at a profit, you could incur capital gains taxes. Some municipal bond interest could be subject to the alternative minimum tax. Municipal bond investing is best suited for investors in higher income tax brackets. The tax benefit these investors derive from the bonds' tax-exempt status is greater than that received by investors in lower income tax brackets, as it generally compensates them for the bonds' lower yields.*

New issue or existing bond?

With a new issue priced at par, you'll be assured of getting back your entire investment, assuming you hold it to maturity and the issuer doesn't default. Also, the costs of buying a new issue may be lower. On the other hand, depending on when the bond was



issued, interest rates and yields on some older bonds might be higher than current rates. In that case, such a bond would trade at a premium to par; at maturity an investor would receive only the bond's par value, not any premium paid at purchase.

Evaluating risk

Many of the factors you should think about when considering a bond purchase have to do with managing the various types of risk associated with bonds. As with any security, the less overall risk, the lower the potential reward; the more risk you're willing to assume, the greater the potential for gain. In addition to market risk involved with most securities, bonds are affected by changes in interest rates, inflation, and the issuer's credit rating, among other things. Understanding a bond's potential risks and rewards can help you manage the level and type of risk you take.

Evaluating interest-rate risk

If you hold your bond until it matures, the direction of interest rates won't affect you. However, if you sell it before maturity, changes in interest rates will affect your return. The interest rate a bond pays (its coupon rate) may be fixed, but its price isn't. Neither is its yield, which takes into account both the coupon rate and the bond's price. Changes in interest rates affect both bond prices and yields.

Bond prices move in the opposite direction from interest rates. When interest rates are rising, bond prices tend to drop. That’s because investors aren’t as interested in buying a bond with, say, a 5 percent interest rate if they can buy a newer bond issue that offers 6 percent. If interest rates fall and new bonds are being issued with a 4 percent interest rate, an older bond that pays 5 percent becomes more valuable and its price rises.

Interest-rate risk (i.e., the possibility of loss due to rising interest rates causing your bond's value to drop) affects all bonds, from Treasury securities to corporate bonds. Even if you plan to hold your bond to maturity, you should keep an eye on interest rates. If you sell the bond early, you could receive either more or less than your original investment.

To estimate how much impact interest rate changes will have on a specific bond, you should consider:

- Its coupon rate: generally, the lower its coupon rate, the more volatile a bond will be
- The time to maturity: generally, prices on long-term bonds will fluctuate more than those for short-term bonds
- Whether or not it is callable: a callable bond's price may not appreciate as much as that of an equivalent noncallable bond when interest rates fall

Managing the interest-rate risk of your bond portfolio typically involves holding your bond(s) to maturity, or trading off some of the higher returns usually offered by long-term bonds for the reduced interest-rate risk of shorter-term bonds.

Evaluating call risk and prepayment risk

If you're relying on income from a bond, you'll probably want to know how long you'll receive that income. If you're counting on receiving interest until the bond matures, you should find out if it's callable (i.e., if it includes a provision that lets the issuer retire the bond early by repaying the loan in full). Call risk means that with a callable bond, you can't be sure how long your income stream will last. Because of call risk, callable bonds may offer a higher yield or a call premium that will be paid only if the bond is called.

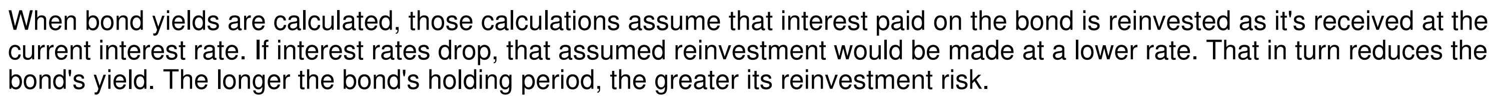
When estimating a callable bond's yield, you should know not only its yield to maturity but its yield to call (i.e., the yield based on the earliest date the bond could be called).

Tip: *Treasury securities typically are not callable.*

Mortgage-backed securities also have prepayment risk. When people pay off their mortgages early (e.g., when they sell their homes, or when interest rates are falling and they want to refinance at a lower rate), your yield from the bond can be affected because the amount of interest paid into the pool of mortgages is reduced. Also, because prepayments typically occur when interest rates are down, you also face reinvestment risk (see below) with the principal that's returned to you.

Tip: *Knowing a bond's call provisions and also what's happening with interest rates can help you evaluate your level of call risk. Estimating the level of prepayment risk for mortgage-backed bonds can be challenging, but generally, the higher the interest rate, the more likely that mortgage prepayments will increase if rates fall.*

Evaluating reinvestment risk



When bond yields are calculated, those calculations assume that interest paid on the bond is reinvested as it's received at the current interest rate. If interest rates drop, that assumed reinvestment would be made at a lower rate. That in turn reduces the bond's yield. The longer the bond's holding period, the greater its reinvestment risk.

Callable bonds are more subject to reinvestment risk than noncallable bonds. Just as a homeowner may refinance to save on mortgage payments when rates fall, a bond issuer can reduce its interest payments by calling your bond and issuing a new one at a lower rate. If the issuer calls a bond, it's likely to happen when interest rates are dropping. If your bond is called and you want to reinvest that money, the interest rate you receive may not provide as much income. Watching the direction of interest rates can help you evaluate your reinvestment risk.

One of your challenges as an investor is to balance reinvestment risk and interest-rate risk. The two work in opposite directions. Interest-rate risk means that if interest rates rise, the value of your bond will drop, though its effective yield will be higher. On the other hand, reinvestment risk means that if interest rates fall, the value of your bond will rise, but its yield will be reduced. Using these offsetting forces to help protect your portfolio is what's known as immunizing your portfolio. Laddering bonds with various maturity dates can also help you manage reinvestment risk.

Evaluating inflation risk

Fixed-rate bonds are exposed to inflation risk (i.e., the reduction in the purchasing power of those fixed interest payments over time because of inflation). If payment amounts are fixed but inflation keeps pushing prices higher, the purchasing power of those interest payments falls and the bond's value drops. The greater the rate of inflation, the less valuable fixed payments become.

One way to manage inflation risk is to select bonds with floating rates (floaters), or inflation-protected securities, such as Treasury Inflation Protected Securities (TIPS). Because interest payments are adjusted based on either prevailing interest rates (floaters) or on the inflation rate as measured by the Consumer Price Index (CPI), such bonds are less affected by inflation than others. You could also reinvest enough of your interest payments to counteract the effect of inflation.

Example(s): *If you have a $10,000 bond that pays 6 percent, you would receive $600 in interest the first year. If inflation is running at 3 percent, you could reinvest enough money to increase your original $10,000 to $10,300--exactly 3 percent more--and use the remaining $300 for income.*

Evaluating default risk

Regardless of whether you plan to hold a bond to maturity, you should know whether its issuer is likely to make payments on time or default on its obligations. Credit ratings can help you evaluate the risk of default. In addition to telling you about the quality of the bond, the letter grades determined by various rating agencies can affect your bond's resale value, especially if that rating changes.

Note: *A credit rating is not a recommendation to purchase a particular bond. Also, credit ratings can change over time, and a change may affect the value of the bond being rated.*

You should also know whether the bond is subordinated debt. If it is, and the bond's issuer can't meet its financial obligations, payments of your interest and/or principal may not be made until more senior debts are satisfied.

If a security is a derivative of other debt instruments, it can be useful to understand the default risk of the underlying securities.

Additional factors to consider

How and when does the bond pay interest?

Some bonds make periodic payments, typically every six months. Others, such as zero-coupon bonds, pay no interest but sell at a discount to their face value. The difference between that discounted price and the face value is the investor's return, which is received at maturity when the principal is repaid.

Note: *The value of zero-coupon bonds is subject to market fluctuation. Because these bonds do not pay interest until maturity, their prices tend to be more volatile than bonds that pay interest regularly. Interest income is subject to ordinary income tax each year, even though the investor does not receive any income payments.*

Treasury bills and U.S. savings bonds also sell at a discount and pay all interest at maturity.

Is the bond selling at a discount or a premium to par?

If a bond is selling at less than its face value, or par, the quoted yield is always higher than its coupon rate, and if you hold it to maturity, you'll likely have a gain. Such gains are generally taxed as ordinary interest income and increase the bond's yield to maturity. If it sells at a premium (i.e., for more than the face value), just the opposite is true. The yield to maturity will be lower than the coupon rate because the yield deducts that premium in calculating your overall return.

Will the bond be affected by currency fluctuations or interest rates overseas?

As with any overseas security, a bond that is not denominated in dollars faces exchange-rate risk (i.e., the potential loss of value because of the strength or weakness of its currency relative to the U.S. dollar). In addition, such a bond will be affected by interest rate movements in the overseas market where it's issued.

Is the bond relatively liquid?

Can a buyer be found relatively easily, or is there a large spread between the bond's bid price and ask price? As with all securities, the narrower the spread, the less liquidity risk you face. For example, because a Treasury security is considered relatively safe, it would be more liquid than a bond from a company in financial difficulty for which you could have trouble finding a buyer. Holding a bond to maturity reduces liquidity risk, though it would not alter the level of default risk.

Evaluating yield

When you're seeking investment income, you may not be comparing a bond to other bonds. For example, you might be considering whether returns from a bond or, say, the preferred stock of a blue-chip company would be better. How do you compare the potential income from very different investments?

One way is to look at their yields. A stock's current yield is a percentage that's calculated by dividing the stock's annual dividend by its current share price. Bond yields are a bit more complicated, partly because there are multiple definitions of yield. The current yield percentage is calculated by dividing the coupon rate by the bond's current price. Yield to maturity estimates what you would earn if you held a bond to maturity and reinvested all interest at the bond's coupon rate when you receive it. Yield to call works the same way, but calculates the return if the bond were to be called at the first possible date.

These three figures may be very different, especially for an older bond. Make sure you understand which is most appropriate to use. For example, if a bond is selling at a premium because it pays a coupon rate that’s higher than newer bonds, it may be called at some point. That means that the yield to maturity may be less useful than the yield to call. However, for a bond that pays all interest at maturity, such as a zero-coupon bond, yield to maturity is the only valid yield figure.

To schedule an appointment with Faye Sykes, click here .

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