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Types of Bonds

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A world of bonds

There are many different ways to categorize and evaluate bonds. That diversity can make buying individual bonds a challenge without some guidance. Traditionally, institutional investors have had much more access to information about bond pricing. However, as baby boomers get closer to retirement age, the bond world has become more transparent and easier to access by individuals. The wide variety of bonds also means that you can tailor the income-oriented portion of your portfolio to reflect your needs, investing style, and time horizon.

Bear in mind that the following categories for types of bonds are not mutually exclusive. If you're considering a bond purchase, you'll need to think about its issuer, its maturity date, its credit rating, its tax status, its size, whether it has any restriction, rights or collateral, and how it pays interest--in other words, all of the following categories.

Bonds by issuer

The terms on which you lend money to someone depends to some extent on who is borrowing the money. There are fundamental differences in bonds, depending on who is issuing it.

Categories of bond by issuer include:

- Corporate bonds. Corporations may borrow money instead of issuing stock to help pay for expansion, equipment or operating expenses.
- Municipal bonds. State and local governments often borrow money to supplement tax revenues and finance projects. Generically called munis, they have traditionally been most attractive for investors in high tax brackets, who benefit from the fact that such bonds have a tax advantage.
- U.S. Treasury securities. The federal government borrows money just as corporations do. It issues bills, notes and bonds to help pay its operating expenses. Because they are backed by the full faith and credit of the U.S. government, Treasury securities are considered the safest of all bonds, and they are typically not taxed at the state or local level. The federal government also issues savings bonds.
- Agency and GSE bonds. Agencies of the U.S. government can issue their own bonds. So can organizations called government-sponsored enterprises (GSEs): private agencies chartered by the U.S. government but not part of it.
- International bonds. As in the U.S., foreign corporations and governments also raise capital by issuing bonds that may be sold in either their home countries or internationally.

Bonds by tax status

Making the choice between taxable versus tax-exempt bonds is often one of a bond investor’s first decisions. In some cases, a tax-exempt bond that pays a lower interest rate can actually yield more than a taxable bond, depending on your tax bracket.

Bonds by maturity

One of the key defining characteristics of a bond is its maturity (i.e., the time between the date of issue and the date when the principal is due to be repaid in full). A bond’s maturity generally affects its coupon rate, its yield, and how dramatic its price fluctuations are likely to be. Maturities can be as short as 24 hours, or as long (in some extreme cases) as 100 years (though 30 years would be more typical).

Bonds by quality rating

Bonds are given a letter grade by a credit agency according to the likelihood that the issuer will pay all interest and principal on time. A bond's credit rating determines whether it is considered investment-grade or not and affects its price and yield.

Bonds by the rights or restrictions attached to them

In some cases, bond agreements include provisions that give either the issuer or the bondholder special rights, such as the right to redeem it early (a callable bond), or the right to convert the bond into shares of a company's stock (a convertible bond). In other cases, a bond may include restrictions that affect how a bond can be redeemed or transferred.

Bonds that have special rights and restrictions include:

- Callable and put bonds
- Convertible bonds
- Registered and bearer bonds
- Senior debt and subordinated debt
- Insured bonds
- Refunded and pre-refunded municipal bonds

Bonds by how they're redeemed or pay interest

Bonds can be categorized by the various ways in which interest is paid or the ways in which they're redeemed. Typical bonds pay periodic interest until maturity, typically every six months. However, others, such as Treasury bills, pay interest only at maturity. The investment community also has developed debt instruments, such as zero-coupon bonds, that pay no interest but are sold at deep discounts to their face values; the difference between that discounted price and the bond's face value takes the place of interest. Some bonds have a fixed interest rate, others a floating rate that is adjusted periodically.

Examples of bonds that are distinguished by the ways in which they pay interest or are redeemed include:

- Zero-coupon bonds
- Floating-rate bonds
- Serial and term bonds
- Super sinker bonds
- Auction rate securities

Structured products also represent a type of bond that is technically a derivative of other investment vehicles--generally, another bond and a derivative based on a different asset class.

Bonds by how the loan is secured

When you lend money to someone, you want some assurance from the borrower that the debt will be repaid. You get that assurance by knowing whether and how a bond is secured, or backed. In many cases, bonds are backed only by the issuer’s promise to pay; how reliable that promise is depends on such factors as the issuer’s reputation and credit history. Such unsecured bonds are called debentures.

In other cases, bonds are backed by a legal claim on specific assets that can be forfeited to the lender if the debt is not repaid. One of the most common examples of a secured bond is a mortgage. Your mortgage is secured by a lien against your house; if you don’t make your mortgage payments, the lender has a legal right to the house. The house serves as collateral for the mortgage. The assets that underlie a bond can affect its performance.

Examples of bonds with backing include:

- Asset-backed bonds
- Collateralized bond obligations (CBOs)
- Collateralized mortgage obligations (CMOs)
- Mortgage-backed bonds, such as pass-through securities, CMOs/REMICs, and equipment trust certificate bonds.

Bonds by size

Most bonds have face values of $1,000 or more. However, so-called baby bonds may be less than $1,000.

To schedule an appointment with Faye Sykes, click here .

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