A Primer for Investing in Bonds

By the Editors of *Kiplinger's Personal Finance*

Bonds belong in your investment plan for a number of good reasons

For a variety of reasons, Americans are increasingly making bonds an important part of their investments. Bonds are basically IOUs, but they're more complex than this popular abbreviation suggests. One way to learn about investing in bonds is with the booklet *A Primer for Investing in Bonds*. Here's a sample of information in the booklet:

A bond is basically a loan issued by a corporation or government entity. The issuer pays the bondholder a specified amount of interest for a specified time, usually several years, and then repays the bondholder the face amount of the bond.

Bonds may belong in your investment plan for a number of good reasons:

- Bonds can provide a predictable stream of relatively high income.
- Bonds offer an opportunity to spread your risk.
- Bonds can generate impressive profits.
- Bonds can provide valuable tax advantages.

Note that the word "safety" doesn't appear on this list.

How Do Bonds Work, Anyway?

Bonds are IOUs issued by corporations (both domestic and foreign), state and city governments and their agencies, the federal government and its agencies and foreign governments. They are issued for periods as short as a few months to as long as 30 years, occasionally even longer.

When you buy a bond, you become a creditor of the issuer; that means the issuer owes you the amount shown on the face of the bond, plus interest. (Bonds typically have a face value of $1,000 or $5,000, although some come in larger denominations.) You get a fixed amount of interest on a regular schedule—every six months, in most cases—until the bond matures after a specified number of years. At that time you are paid the bond's face value. If the issuer goes broke, bondholders have first claim on the issuer's assets, ahead of stockholders.

After bonds are issued, they can be freely bought and sold by individuals and institutional investors in what's called the secondary market, which works something like a stock exchange.

Many different types of entities issue bonds. Among them:

Corporations. They may issue secured bonds, which are backed by a lien on part of a corporation's plant, equipment or other assets. Or they may issue debentures, which are unsecured bonds, backed only by the general ability of the corporation to pay its bills.

Municipal bonds are issued by state or city governments, or their agencies. Interest paid on municipal bonds is generally exempt from federal income taxes and usually income taxes of the issuing state as well. **General obligation bonds** are backed by the full taxing authority of the government that issues the bonds. **Revenue bonds** are backed only by the receipts from a specific source of revenue, such as a bridge or highway toll.

U.S. Treasury debt obligations are backed by the full faith and credit of the federal government. Interest from Treasuries is exempt from state and local income taxes but not from federal income tax.

Agency securities are issued by various U.S. government-sponsored organizations, such as the Tennessee Valley Authority. Although they are not technically backed by the full faith and credit of the U.S. Treasury, they are widely considered to be moral

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For contact information for your State Securities Regulator, visit the North American Securities Administrators Association (NASAA) Web site at www.nasaa.org and click on "Contact Your Regulator."

HOW TO ORDER INFORMATION

Get more resources and tools

A variety of noncommercial investor education and protection materials, including booklets, videos and curricula, are available and can be downloaded for educational purposes at **www.investorprotection.org**.

About the Investor Protection Trust

The Investor Protection Trust (IPT) is a nonprofit organization devoted to investor education. More than half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993 the Investor Protection Trust has worked with the States and at the national level to provide the independent, objective investor education needed by all Americans to make informed investment decisions. For additional information, visit www.investorprotection.org.

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The Investor Protection Institute (IPI) is an independent nonprofit organization that advances investor protection by conducting and supporting unbiased research and groundbreaking education programs. IPI carries out its mission through investor education, protection and research programs delivered at the national and grassroots level in collaboration with state securities regulators and other strategic partners. IPI is dedicated to providing innovative investor protection programs that will make a meaningful difference in the financial lives of Americans in all walks of life and at all levels of sophistication about financial matters. For additional information, visit www.protectinvestors.org.

Just how do bonds work, anyway? Here are the keys to unlocking the real potential of bonds.

A Primer for Investing in Bonds

You're better off using funds to buy risky bonds.

obligations of the federal government.

Treasury inflation protected securities, or TIPS, are Treasury bonds that adjust with changes in consumer-price inflation.

How Much Does a Bond Really Pay?

When a new bond is issued, the interest rate it pays is called the coupon rate, which is the fixed annual payment expressed as a percentage of the bond's face value. A 5% coupon bond pays $50 a year interest on each $1,000 of face value, a 6% coupon bond pays $60 and so forth.

One of the most important things you need to know about bonds is that as interest rates rise, bond prices fall; as interest rates fall, bond prices rise. Because of this relationship, the actual yield to an investor depends in large part on where interest rates stand on the day the bond is purchased. So the vocabulary of the bond market needs more than one definition for yield.

Current yield is the annual interest payment calculated as a percentage of the bond's current market price.

Yield to maturity includes the current yield and the capital gain or loss you can expect if you hold the bond to maturity.

How to Reduce the Risks in Bonds

Inflation and rising interest rates are two of the biggest risks bondholders face. Inflation erodes the value of those fixed payments to bondholders. If investors see inflation accelerating, they are likely to demand higher interest rates to lend money. How can you reduce these risks?

- Don't buy long-term bonds when interest rates are low or rising.
- Stick to short- and intermediate-term issues.
- Acquire bonds with different maturity dates to diversify your holdings.

Default risk. Another risk is the chance that the issuer won't be able to pay off bondholders. To guard against this risk:

- Check the rating of any bond you're considering purchasing. Ratings from such firms as Moody's and Standard & Poor's are available online and at public libraries.
- Spread your bond holdings across several different issuers, whether corporate or municipal.

Going the Mutual Fund Route

Many investors may prefer owning bonds through managed vehicles, such as mutual funds. Funds are convenient. They let you spread your risk and provide professional management. But they have their drawbacks. If you invest in a fund, for example, you don't know in real time which bonds you own (most funds report their holdings quarterly). You'll have to pay management fees and, perhaps, sales charges. And, except in rare instances, a fund doesn't mature. So when you sell your shares, you may get more money than you paid, or the same amount, or possibly even less.

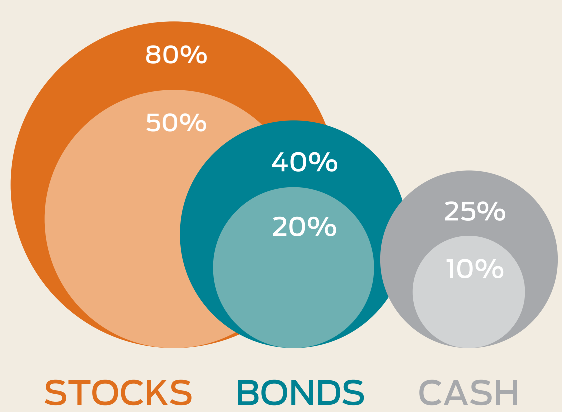
More information. To read the full-length *A Primer for Investing in Bonds* booklet, visit www.investorprotection.org or contact your State Securities Regulator's office.

REBALANCE YOUR INVESTMENTS

Complete this worksheet at least once a year so you'll know how your investment mix is changing. Then take action to bring it back into line with a mix that matches your goals and your risk tolerance.

	MARKET VALUE	PERCENT OF TOTAL
CASH		
Savings accounts	$__________	____%
CDs	$__________	____%
Money-market funds	$__________	____%
Treasury bills	$__________	____%
TOTAL CASH	$__________	____**%**
STOCKS		
Individual shares	$__________	____%
Mutual funds	$__________	____%
ETFs	$__________	____%
TOTAL STOCKS	$__________	____**%**
BONDS		
Individual bonds	$__________	____%
Mutual funds	$__________	____%
ETFs	$__________	____%
TOTAL BONDS	$__________	____**%**
Rental real estate	$__________	____%
Limited partnerships	$__________	____%
Precious metals	$__________	____%
Collectibles	$__________	____%
Other investments	$__________	____%
TOTAL INVESTMENTS	**$**__________	____**%**

HOW TO DIVERSIFY



Think in terms of ranges rather than fixed percentages when deciding how to divvy up your investments. A diverse portfolio allows you to manage risk and adjust according to the market and your time horizon.

THE TRADITIONAL RISK PYRAMID

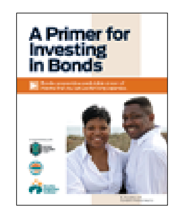
The higher up the pyramid, the higher your potential reward and the greater your risk of loss—and the smaller the proportion of your investments.

MORE INFORMATION ABOUT INVESTING

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine and the Investor Protection Trust are available at your library and offices of State Securities Regulators.

Five Keys to Investing Success
Make investing a habit
Set exciting goals
Don't take unnecessary risks
Keep time on your side
Diversify

The Basics for Investing in Stocks
Different flavors of stocks
The importance of diversification
How to pick and purchase stocks
When to sell
Key measures of value and finding growth
What's your return?
Consider mutual funds



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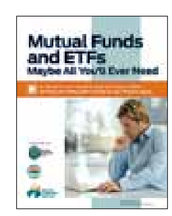
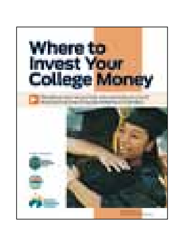
How do bonds work, anyway?
How much does a bond really pay?
How to reduce the risks in bonds
Going the mutual fund route



Mutual Funds and ETFs: Maybe All You'll Ever Need
Mutual funds: The best investment
The different types of funds
How to choose funds
Assembling a portfolio
Sources of mutual fund information
Where to buy funds

Maximize Your Retirement Investments
Three key rules
Creating the right investment mix
Investing on target
Best places to save
Guidelines for saving at every life stage
Getting the money out and creating an income stream
Protect your money: Check out a broker or adviser

Getting Help With Your Investments
Do you need a financial adviser?
Who's who among financial advisers
How to choose an adviser
How to open an account
5 questions to ask before you hire an adviser
What can go wrong
How to complain



Where to Invest Your College Money
The basics of investing for college
Investing in a 529 savings plan
Locking in tuition with a prepaid plan
Other tax-favored ways to save
Tax credits for higher education
Save in your child's name?

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