Advantages and Disadvantages of Bonds

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WHAT'S COVERED

In this lesson, you will learn about the advantages and disadvantages of bond ownership. Specifically, this lesson will cover:

1. Advantages of Bonds

Recall that a bond is an instrument of debt, with the issuer being the borrower and the holder being the lender.

1a. Price Movement

One advantage that bonds have over stocks is that they have relatively low volatility in terms of price. This means that the shift in price changes for bonds is usually smaller than that of stocks. Due to this, they seem to be a safer, more conservative investment. Also, because there is some relative certainty that the fixed interest payment twice a year will happen along with the fixed interest payment at maturity, bonds can be very attractive.

1b. Legal Protection

This attraction is also related to the fact that there is an element of legal protection that is present with bonds. If the bond issuer goes bankrupt, bondholders usually receive some money back during the recovery process. The company's stockholders end up with nothing.

HINT

The bond indenture outlines these terms.

1c. Liquidity

The third advantage is that bonds are usually very liquid. It's easy for a financial institution that has invested heavily in bonds to sell a substantial quantity of them without moving the price. This is much more difficult to do with stocks.

1d. Variety

Finally, because finance is an area in which new products are created to fulfill almost every need, there is usually a type of bond available to meet the different needs of investors, including zero-coupon bonds, convertible bonds, and floating-rate bonds, to name a few.

2. Disadvantages of Bonds

Bonds are subject to various types of risk.

2a. Interest Rate Risk

One type of risk is interest rate risk. Bonds that have fixed coupon rates – and this is most of them – are subject to interest rate risk. Since the coupon payments are fixed, when market interest rates rise, the price of the bond will fall. This tells us that investors will be able to get a higher interest rate on their money somewhere else in the market. Perhaps they will invest in a newly issued bond that reflects the higher interest rate.

2b. Repayment Risk

Bonds are also subject to repayment risk. This is for bonds that are callable. There's the risk that a bondholder's specific bond will be called for early repayment by the issuer.

2c. Credit Rating Risk

There is also credit rating risk on the part of the issuer. If a credit rating agency downgrades its rating of the issuer, the market price of the bond will fall. And just as we saw with interest rate risk, it doesn't affect the interest payments, but it does affect the price. This would affect the holders of these bonds who may be seeking to sell them.

SUMMARY

In this lesson, we learned that the **advantages of bonds** include the relative lower volatility of bond prices when compared to stocks. This means **prices change** in smaller amounts because they are seen as less risky and more conservative. There is also an amount of **legal protection** for bondholders through the bond indenture. If the issuer declares bankruptcy, the bondholder will receive some payment on the bonds they hold. Bonds are also very **liquid**, and this is important because it ensures bondholders can trade large quantities of bonds without significantly impacting prices. There are also a **variety** of bonds to meet the needs of different investors.

The **disadvantages of bonds** include several types of risk that can impact bondholders.**Interest rate risk** stems from the fact that fixed coupon payments do not change when overall market interest rates increase. There is also **repayment risk** for bonds that are callable. A bondholder may be unwilling to surrender a bond in their portfolio if it is attractively priced at the time it is called. There is also **credit rating risk**. If a credit rating agency changes the credit rating for an issuer and lowers it, then the price for the bond will fall in the market.

Best of luck in your learning!

