Bond Risk

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the characteristics of various types of bond risks. Specifically, this lesson will cover:

1. Interest Rate Risk

Interest rate risk is the uncertainty associated with changes in the price of a bond caused by changes in the general interest rate levels in the economy. Since coupon payments are fixed, if general interest rates fall, bond prices increase. If interest rates rise, bond prices fall. However, if the bondholder is holding the bond to maturity, he is insulated from this interest rate risk.

> EXAMPLE If a bondholder is holding a bond paying a 6% coupon and general interest rates fall, he will continue to receive 6% coupon payments.
>
> If interest rates rise, the bondholder may have opportunities to invest at a higher rate, but as long as he holds the bond at 6%, that is the return he'll receive.

TERM TO KNOW

Interest Rate Risk
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2. Reinvestment Risk

The other side of the coin is reinvestment risk. Reinvestment risk is the uncertainty that the holder will be able to reinvest his funds at the same rate, or better rate, at maturity.

If a bond is callable and interest rates fall, it is more likely that the issuer will call the bond while the holder is enjoying the higher fixed coupon payment. This shows that reinvestment risk and interest rate risk are inversely related. An investor could moderate one or the other, but they cannot eliminate both.

TERM TO KNOW

Reinvestment Risk

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The risk that a bond is repaid early, and an investor has to find a new place to invest with the risk of lower returns.

3. Default Risk

The **default risk** is the risk that the bond issuer will not make payments as scheduled. If payments are missed and it goes bankrupt, investors may lose much, if not all, of their money.

In bankruptcy, bank lenders are very high in the precedence of being paid back from liquidation. Bondholders have precedence over equity holders and have a certain amount of legal protection. If a company goes bankrupt, its bondholders will often receive some money back. The company's common stockholders usually end up with nothing.

When a company can't pay its obligations, it enters bankruptcy court. There are two types of bankruptcy for which a corporation can file:

- *Chapter 11:* With this bankruptcy code, the business remains intact and in control of management but it is subject to the oversight of the court.
- *Chapter 7:* With this bankruptcy code, the company stops operating, the trustee of the court sells all the assets, and then distributes the proceeds to the creditors.

TERM TO KNOW

Default Risk

The risk that a bond issuer will default on any type of debt by failing to make payments which it is obligated to make.

SUMMARY

In this lesson, we learned that **interest rate risk** is the uncertainty of the impact of general economic rate changes on the price of a bond. If rates fall, the bondholder can still enjoy the higher coupon payment rate.

Reinvestment risk is the uncertainty that the bondholder won't be able to reinvest funds at the same rate. This could be encountered when rates fall or conditions when callable bonds are likely to be redeemed.

And finally, **default risk** reflects the possibility that the issuer will not make a coupon or maturity payment as scheduled.

Best of luck in your learning!

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