Types of Bonds

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WHAT'S COVERED

In this lesson, you will learn about different types of bonds. Specifically, this lesson will cover:

1. Government Bonds

Very frequently, products find their way to the market when there is a vacuum; the bond market is no exception.

One type of bond is the **government bond**. We consider a government bond to be issued by the US government, but they actually can be issued by any national government.

DID YOU KNOW

Outside of the United States, they are called sovereign bonds.

In the US, government bonds are usually referred to as risk-free bonds because the government can raise taxes or create additional currency in order to redeem the bond at maturity.

TERM TO KNOW

Government Bond

A bond issued by a national government denominated in the country's domestic currency.

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2. Zero-Coupon Bonds

Zero-coupon bonds are an instrument that was first introduced in the 1960s and became popular in the 1980s.

Zero-coupon bonds are also called discount bonds, and the reason it's called a discount bond is that it does not make periodic interest payments; the coupon rate is zero.

With a zero-coupon bond, the investor does not receive coupon payments, but does receive the face value at maturity.

HINT

Because zero-coupon bonds pay zero interest, they are issued at a substantial discount to face value so that the interest is effectively included in what gets paid at maturity.

TERM TO KNOW

Zero-Coupon Bond

A bond with no coupon payments, bought at a price lower than its face value, with the face value repaid at the time of maturity.

3. Floating-Rate Bonds

While coupon rates are most often fixed, there are bonds that have variable coupon rates. These are called **floating-rate bonds**, or FRBs. The spread is the rate that is tied to an index like the federal funds rate, and they have quarterly coupons.

In the US, issuers of floating-rate bonds are government-sponsored enterprises, such as:

- Federal Home Loan Bank
- Federal National Mortgage Association (also called Fannie Mae)
- Federal Home Loan Mortgage Corporation (also called Freddie Mac)

Floating rate bonds have very little interest rate risk when the market rates are the actual expected coupon rates of the floating rate bonds. This is different than fixed-rate bonds, whose prices decline when markets rate rise. For this reason, there is almost no interest rate risk with floating-rate bonds.

TERM TO KNOW

Floating-Rate Bond

A bond that has a variable coupon equal to a money market reference rate (e.g., LIBOR), plus a quoted spread.

4. Other Types of Bonds

There are other several types of bonds as well.

Other Types of Bonds	Description
Inflation-linked bonds	Floating rate bonds with an index that is tied to the inflation rate.
Convertible bonds	Bonds that let the bondholder trade the bond for a number of shares of common stock.
Asset-backed securities	Bonds whose cash flows are backed by the output of other assets, like mortgage-backed securities.
Subordinated bonds	Bonds that have a lower priority than other bonds in the case of liquidation. These bonds would typically have a slightly higher return to compensate for the increased default risk.

TERMS TO KNOW

Inflation-Linked Bond
A floating-rate bond with an index that is tied to the inflation rate.

Convertible Bond
A bond that lets the bondholder trade the bond for a number of shares of common stock.

Asset-Backed Security
A bond whose cash flows are backed by the output of other assets, like mortgage-backed securities.

Subordinated Bond
A bond that has a lower priority than other bonds in the case of liquidation.

SUMMARY

In this lesson, we learned that we have **government bonds** issued by national governments. These are also called sovereign bonds. We have **zero-coupon bonds** that have no coupon payment and therefore sell at a deep discount below face value. There are also **floating-rate bonds** that are fixed to an index. Issuers of these bonds include Fannie Mae and Freddie Mac. **Other types of bonds** are inflation-linked bonds, convertible bonds, asset-backed securities, and subordinated bonds.

Best of luck in your learning!

TERMS TO KNOW

Asset-Backed Security
A bond whose cash flows are backed by the output of other assets, like mortgage-backed securities.

Convertible Bond
A bond that lets the bondholder trade the bond for a number of shares of common stock.

Floating-Rate Bond
A bond that has a variable coupon equal to a money market reference rate (e.g., LIBOR), plus a quoted spread.

Government Bond
A bond issued by a national government denominated in the country's domestic currency.

Inflation-Linked Bond
A floating-rate bond with an index that is tied to the inflation rate.

Subordinated Bond
A bond that has a lower priority than other bonds in the case of liquidation.

Zero-Coupon Bond

A bond with no coupon payments, bought at a price lower than its face value, with the face value repaid at the time of maturity.