Understanding Bonds

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WHAT'S COVERED

In this lesson, you will learn about the basic characteristics of bonds. Specifically, this lesson will cover:

1. Understanding Bonds

A bond is an instrument of debt; it is a debt security. Bonds provide a way for government and businesses to borrow money in large amounts for a longer period of time.

When an entity issues bonds, it is borrowing money. In the primary market, when an investor buys a bond, it is lending money. The terms of the bond require that the borrower pay the bondholder interest, which is also called the coupon rate. It also requires that they repay the principal at a later date. This is the par value, or face value, that is paid at maturity. The coupon interest is usually paid semi-annually, or every six months.

Bonds can be issued by:

- Public authorities
- The federal government
- State governments
- City and county governments
- Municipalities
- Credit institutions
- Companies themselves
- Multinational institutions

Companies and individuals themselves can purchase bonds. Because these bonds are negotiable, ownership of them can be transferred in the secondary market, as if you or I were to invest in bonds. We are not lending money to the entity that issued them, but we are paying for the current bondholder to transfer that security to us.
A bond is a form of a loan. The holder of the bond is the lender; the creditor and the issuer of the bond is the borrower, or the debtor. The interest rate is the coupon. These bonds provide the buyer with external funds to finance long-term investments, and in the case of government bonds, they finance current expenditures.

Certificates of deposit (CDs) or short-term commercial paper are not considered to be bonds. They are considered to be money market instruments because the length of term is much shorter than the term for bonds.

2. Types of Bonds

There are different categories of bonds. There are **corporate bonds** that are issued by companies. **Municipal bonds** are issued by state, county, and local governments. Also, the United States Department of Treasury issues **Treasury bonds**, notes, and bills, which altogether are referred to as treasuries.

There are two features of a bond that are the main determinants of a bond's coupon rate:

- Credit quality
- Time to maturity

HINT

Maturities range from a one-year Treasury bill to a 30-year government bond. Corporate and municipal bonds are often in the 3 to 10-year range, but can be longer.

TERMS TO KNOW

Corporate Bond
A bond issued by a corporation to raise money effectively in order to expand its business.

Municipal Bond
A bond issued by an American city or other local government, or their agencies.

Treasury Bond
A government debt issued by the United States Department of the Treasury through the Bureau of the Public Debt, with a maturity of 20 years to 30 years.

3. Contract for the Bonds

The **bond indenture** is the legal contract issued to the lenders that states all of these terms. The specifications given defines the responsibilities and commitments of the issuer, as well as those of the borrower, and describes all the key terms including the interest rate, the maturity date, and the repayment dates. If it is **convertible**, any representations, covenants, or other terms of the bond offering are stated. If the borrower fails to meet any of those payment requirements, the results can be drastic, including bankruptcy and liquidation.

Because it would be impractical for corporations or any other issuer to enter into an agreement with each individual bondholder, the bond indenture is held by a trustee. This is usually a commercial bank or some other financial institution. They are appointed to represent the rights of the bondholders.

When the bonds are originally issued in the primary market, there is an offering memorandum that is prepared in advance of the marketing of the bond, and the indenture is summarized in a section called the description of notes. This offering memorandum, usually called a prospectus, is the document that describes the bond for potential buyers. The prospectus also provides information about the company's business, financial statements, its executives, information about their compensation, and any litigation that might be taking place, along with any other material information.

TERMS TO KNOW

Bond Indenture

A legal contract issued to lenders.

Convertibility

Quality of a bond that allows the holder to convert into shares of common stock in the issuing company or cash of equal value, at an agreed-upon price.

4. Bond Ratings

In finance, the bond's credit rating reflects the creditworthiness of the corporation or the government's debt issuer. It's similar to an individual's credit rating. The quality of the bond refers to the probability that the bondholders will receive the coupon payments and the maturity payments on their due dates. The higher the credit rating, the lower the interest cost is to the issuer.

Bond ratings are created by **credit rating agencies**. These include Moody's, Standard and Poor's, and others. Ratings are usually given in letter designations starting with AAA and going down through BBB, CCC, and lower. A bond is considered to be investment grade if its credit rating is BBB or higher in the Standard and Poor's rating. A bond rate lower than this is not considered to represent investment grade bonds. Those that are very low are usually called junk bonds, or high-yield bonds. These bonds are rated much lower than investment grade bonds and offer a higher yield because the investor has to take on more risk to earn a higher coupon rate.

Credit rating agencies are paid for their work largely by investors who want impartial information. Later, though, they began to be paid by entities issuing the securities, and this led to charges that they could not be as impartial as they had in the past. Still today, rating agencies' work is thought to be highly respected and, for the most part, very impartial.

TERM TO KNOW

Credit Rating Agency

A company that assigns credit ratings to issuers of certain types of debt obligations, as well as to the debt instruments themselves.

SUMMARY

To **understand bonds**, the first thing to note is that a bond is a debt instrument, where the issuer is the borrower, and the investor is the lender. Different **types of bonds** can be issued by corporations, state and local governments, and the federal government. The bond is a loan that makes interest payments to the bondholder, usually every six months until maturity. At maturity, the face value is repaid.

All of the details of the bond offering are included in a legal **contract** called the bond indenture. This indenture is held by the trustee, which is usually a financial institution.

Finally, the credit **ratings of a bond** reflect the creditworthiness of the corporation or government bond issuer. Similar to a credit rating, the rating of the bond impacts the interest rate the issuer has to pay as well as the risk assumed by the borrower.

Best of luck in your learning!

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