CAPITAL ACCUMULATION

BONDS

BONDS

A bond is a promise to pay interest at a fixed rate (coupon rate) and to redeem the promise at a predetermined time for more money than you paid when you first bought it. Because there is no uncertainty as to the amount of interest income one might expect form a bond and the redemption price is set before the initial purchase, a bond is referred to as a fixed income investment. The main risk is the financial stability of the issuing entity. Stocks and bonds share this uncertainty. The ability of the issuer of both to meet its obligations in the future is unknown.

KINDS OF BONDS

There are three main kinds of bonds each having numerous sub classification. There are Corporate Bonds, Municipal Bonds and U.S. Government Bonds.

CORPORATE BONDS

Utilities are the largest issuers of corporate bonds, followed by private industry, finance companies and real estate organizations.

Mortgage Bonds. Mortgage bonds are bonds secured by a mortgage on all or a portion of the fixed property of the borrower. Utilities almost always issue mortgage bonds because the collateral offered (a lien against real assets) is a needed enticement to investors.

Debenture Bonds. Debenture bonds are unsecured. They do not offer collateral for their loans but only the credit of the issuing corporation. That means holders of debenture bonds are in line to be paid off after the secured lender (holders of mortgage bonds for instance). As their name implies, subordinated debentures are subordinated to senior debt and income debentures are only paid interest if and when it is earned. If the company experiences financial difficulty the interest may be accumulated slowly but must, at any rate, be paid to the income debenture bond holders before dividends are paid to any stockholders. Convertible bonds may, at the holder's option, be converted to stock; not as safe as bonds but more speculative and desirable under certain market conditions.

MUNICIPAL BONDS

Municipal bonds are issued by local and federal governments and secured in several ways. The highest security is offered by *General Obligation Bonds*. The full faith and credit of the borrower is hard to beat when that borrower has unlimited taxing powers.

Special and Limited Tax Bonds are backed only by a potion of that taxing power. Often the borrower is restricted to paying interest from only one special tax.

Revenue Bonds are paid from the proceeds of the self-supporting projects for which they were raised.

Because the federal government backs local Housing Bonds these bonds are among the most secure and are consequently awarded high ratings.

The most important and best publicized feature of Municipal Bonds is the fact that they are exempt from deferral and sometimes state and local taxation. When compared to the after-tax yield of other investments, municipal bonds can be quite attractive. We will discuss them again in the Tax Management workbook as a vehicle for reducing taxes.

GOVERNMENT BONDS

U.S. Savings Bonds. Most of us are familiar with U.S. Savings Bonds. They have been a typical birthday or Christmas gift from a distant Aunt and Uncle. How many 13-year-olds have received savings bonds for their Bar Mitzvahs or birthdays during the past 40 years? Savings Bonds or E Bonds are registered so the birthday child's name is on the security which makes it extra special! These bonds can not be called* before maturity and are not transferable. Series EE are sold with a face-value of $25 up to $100,000. The maximum annual purchase allowed an individual is $10,000. Savers and investors can open an on-line account to purchase EE Bonds in electronic form through Public Debt's website www.treasurydirect.gov. Account holders can purchase, and redeem electronic EE Bonds over the Internet 24 hours a day, seven days a week. They are frequently used to fund employee savings plans. They are issued at a discount so don't pay interest but the yield at maturity, or whatever date you choose to redeem them (redeemable after two months) is comparable to interest and is compounded semiannually. Of course the longer you hold the Bond the better your return. Rates for new issues are adjusted each May 1 and November 1, with each new rate effective for all bonds issued in the six months following the adjustment Savings Bonds cannot be sold in the market place. Since they are non-transferable securities, they cannot be used as collateral for a loan but can only be redeemed by the government. There is no state or local tax on savings bonds and federal income tax is deferred on EE Bonds but not H Bonds until the bonds are redeemed. This is a useful and money saving feature which will is discussed in more detail in another workbook.

Series HH Bonds are sold at their face-value and pay interest twice a year. The lowest denomination is $500 and the maximum purchase allowed in one year, as in the EE Bonds, is $10,000. You must hold HH Bonds at least six months after the issue date before attempting to redeem them.

Treasury Bonds. These are backed by the United Stated Government and they make up most of the federal debt. They can be purchased in bearer or registered form. They are considered long term debt and generally take ten years to mature. Interest rates naturally change over a long period of time. When the rates offered in new issues is higher than what your earlier issued bond is paying the price of the earlier bond naturally declines; i.e. if you were to sell it before maturity. If you hold it until maturity it can be redeemed for face-value. However, the higher interest that you could have had from some other investments is still sacrificed.

OTHER GOVERNMENT SECURITIES

U.S. TREASURY BILLS

U.S. Treasury Bills are sold at a discount and mature in three-six-nine- and twelve months. They don't pay interest but your profit (difference between what you paid for them and what they were redeemed for) is comparable to interest. They are issued only in bearer form with a minimum purchase of $10,000 required.

TREASURY NOTES

Treasury Notes are securities that pay interest every six months. Their maturity dates range form one to ten years. Here also there is a minimum purchase requirement of $10,000. You can buy government securities through your broker or bank. New issues can be bought directly from the Federal Reserve without service charges or commission. Because of the large amounts involved you can see that this action should be the domain of the sophisticated, knowledgeable investor. There are books listed at the end of the chapter that will satisfy your curiosity and with some study and continued effort government securities may be the ideal investment for you one day.

CONTRASTED WITH STOCK

If you buy stock you become an owner and expect to share in the company profits. If you buy bonds, however, you become a lender and expect a fixed amount of interest. After the Second World War the yield on stocks was double that of bonds. In the 1970s that situation was reversed. Thanks to compounding high interest rates, investments in bonds often doubled in nine or ten years. Compounding meant that an investor received interest, not only on the principal amount invested, or in the case of bonds, the face value of the bond but interest was paid on the accumulated interest also. Compounding is a bonanza for the investor who receives interest on his interest. To top it off, bonds offer greater protection against wild or hostile economic conditions than stocks do.

YIELD

A yield on stock is computed by dividing the dividend by the purchase price. Similarly, to determine the yield on bonds, divide the interest by the price you paid for the bond. For example: $1,000 bond pays 10%/year and you bought it for $900. Remember, interest is paid on the face value; therefore 10% of $1,000 is $100. The yield is 100 divided by 900 or approximately 11%. It should be noted that yield to a maturity would be higher because in addition to interest you would receive an extra $100 more than you paid for the bonds.

BOND RATINGS

All bonds are rated according to the credit worthiness of the issuing entity (borrower). The most secure are rated AAA down to AA, to A and on through BBB and CCC to the most risky grade, C. Along with yield and market price the rating is of prime importance when analyzing a potential investment in the bond market.

CALL PROVISIONS*

Another consideration is the presence or absence of a call provision. Calls are discussed more fully in another workbook so the description here is a summary. An investor buys a bond with the idea of receiving a fixed interest income over a period of time. A call provision allows the issuer to call these bonds should interest rates decline below the levels at which they were sold and to replace them with new issues bearing lower rates. There are certain restrictions such as the price at which the entity reserves the right to call in its bonds and the time which must elapse before a call is permitted. Often you can get a five-year protection against calls which would in effect guarantee the interest rate you purchased for at least that period of time. Naturally, look for bonds without call provisions whenever possible.

DISTINGUISHING BETWEEN BEARER AND REGISTERED BONDS

Receiving interest on your bearer bonds is not the automatic operation you may be used to in your savings account. You must take an active role in obtaining it. A bearer bond is like cash and should be treated as such. If you lose it it's finders keepers; you have less proof of ownership than you do with a traveler's check. These bearer bonds have coupons attached to them which you must clip and redeem at a bank in order to receive your interest.

Registered bonds have your name on them and are registered with the issuer who sends you a check when the interest is due. This makes them not only safer but more convenient than bearer bonds.

HOW TO BUY BONDS

The face value of a bond is the amount the issuer will pay when the bond is redeemed at maturity. Bonds are sold at a percentage of their face value but interest is paid on the whole face value. A bond that is bought at a premium is bought for more than its face value. You might wonder why anyone would pay more for a bond currently than what he can get for it in the future. The attraction is the interest rate. A person buying a bond at a premium would be acting on a belief that interest will fall in the future. His aim would be to capture what he believes to be a high interest rate now.

Underwriters function as wholesalers between the borrowing institution and the investor (lender). They in effect, buy the bond issue from the borrowing entity at a certain figure and resale it to the individual investor at a higher price; the underwriters mark up.

It is possible to purchase bonds from the Federal Reserve. There are also many bond funds available, similar in concept to stock oriented mutual funds. These bond funds are professionally managed and may constitute a variety or a selection of only one type of bond. The all government bond funds are popular because of the security they offer. Frequently bonds are chosen and put into a trust called a unit investment trust. The trustee, generally an investment banker or broker, then sells units in the trust to investors.

SUMMARY

Bonds are usually considered a safer investment, more conservative, than the stock market. A bond holder is a lender with fixed interest income rather than a partial owner facing future losses or profits. But bonds are not without their pitfalls. There are three main kinds of bonds: U.S. Government, Municipal and Corporate. The government bonds offer the greatest safety; the municipals are tax-exempt; and the corporate bonds offer the greatest monetary rewards. The two biggest enemies facing the bonds market are high inflation and high interest rates. It is conceivable that inflation could rise high enough to offset all growth. Thanks to inflation, the investor's purchasing power would be the same as the year the investment was made. During periods of high interest, prices of bonds issued during earlier lower interest years would be depressed. However, this in itself would not greatly affect the holder who could afford to keep the bond to maturity. On the other hand, those forced to sell earlier would have to suffer large discounts due to the high interest rates an investor could get form the new bond issues.

Worksheet

A CHECKLIST FOR THOSE CONSIDERING THE BOND MARKET

1. Are safety and income your prime objectives?
2. How long do you want to leave your savings in a fixed-income medium?
3. Can you afford to take risks?
4. What do you think the inflation rate will be in 2 years?
5 years? ___________10 years $ ___________20 years? ___________
5. Will your interest coupons cover any annual loss of purchasing power your invested dollars may suffer if your inflation predictions are realized?
6. What do you think interest rates will be in 2 years?
5 years? _____________ 10 years? ______________ 20 years? _____________
7. If your interest rate predictions come true and if they should depress the bond market, do you have enough other assets so that you can be certain of holding your bonds to maturity and not

suffer large discounts?
8. Do you have a large enough sum to invest to meet requirements?
9. Have you considered the commission charge on small "lots"?
10. Are you willing to accept the responsibility for this investment and obtain the knowledge needed?
11. Would you feel more comfortable with your savings in a bank or other savings institution?
12. Have you computed the difference you would achieve by placing your investment in a savings institution vs. the bond market on a (1) best situation scenario (2) stay the same (inflation & interest) and (3) worst scenario?
13. Have you considered a professionally managed bond fund?
(consult with your banker or broker)

RECOMMENDED READING

Bonds, by Robert Lawrence Holt
The Handbook of the Bond & Money Markets, by David Darst
The Complete Bond Book, by David Darst
Municipal Bonds, by Lamb & Rappaport
How to Invest in Bonds, by Hugh Sherwood

Search for Bonds on Amazon books
Bond information and to find yields
http://www.fmsbonds.com/Market_Yields/index.html?source=google&kw=bond%20yields'%20online&gclid=CMCzzcCnpZgCFQkzawodbgmXmA

Government web sites
RS web site has information http://www.irs.gov/pub/irs-tege/trng_phaseiia.pdf

Buy bonds direct from the U.S. Treasury http://www.treasurydirect.gov/