



The ABCs of Bonds

More Than Stocks

You hear about the stock market almost every day, especially in current times with all the volatility. But there's more to investing than stocks. Another very important component of the investing arena is bonds.

Having bonds as part of your investment mix adds diversification to your investment portfolio and may help cushion it against major losses if the stock market drops.

The Bond Universe

There are many types of bonds, but they all have one characteristic in common – they all represent debt. When you buy a bond, you're essentially lending money to a government, corporation, municipality, federal agency, or other issuer. In return, the bond issuer agrees to pay you a specified amount of interest over a certain period of time. At the end of that time – the bond's maturity date – the issuer promises to pay you the bond's face value.

By looking at interest rates, time to maturity, credit quality, and tax status, you'll have a better idea of which bonds are appropriate for your financial goals.

- ♦ **Treasury bonds** are issued by the U.S. Government and have maturities of up to 30 years. Interest is paid every six months. Interest generated by Treasury securities is subject to federal income taxes but is exempt from state and local taxes.

- ♦ **Agency bonds** are issued by federal government agencies and government-sponsored entities, including mortgage associations like Fannie Mae and Ginnie Mae. Interest on some agency bonds is exempt from state and local taxes.

- ♦ **Municipal bonds** pay for construction and other projects of state, county, and city governments and other governmental entities. Investors in high tax brackets may find municipal bonds appealing because they're generally exempt from federal, and sometimes state and local, income taxes.

- ♦ **Corporate bonds** – issued by companies to raise money for expansion and other projects – offer potentially higher yields than governmental bonds but also present more risk to your principal. They usually require a relatively large minimum investment, so you may want to consider investing in corporate bonds through a mutual fund. Low-quality corporate bonds, known as "junk bonds," typically offer higher yields than other bonds but carry a greater probability of default.

No investment is 100% safe, including bonds

While not as volatile as stocks, bonds do have risks, including the loss of principal. The most common risk is *interest rate risk*. When interest rates rise, prices of outstanding bonds fall, and vice versa. Bondholders may have to sell

existing bonds at a discount if they want to purchase new bonds.

A second risk that bonds face is *default* or *credit risk*. That's the risk that the issuer will be unable to pay interest or repay principal. It's a risk common to low-rated bonds. Bond rating services, such as Standard and Poor's or Moody's, rank bonds as either investment grade or below investment grade.

Maturity risk is yet another risk associated with bonds. Owning long-term bonds is riskier than owning short-term bonds since the future performance of the financial markets is impossible to predict. Issuers of long-term bonds generally compensate for the extra risk by offering higher yields.

Diversification does not guarantee gains nor prevent losses.

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