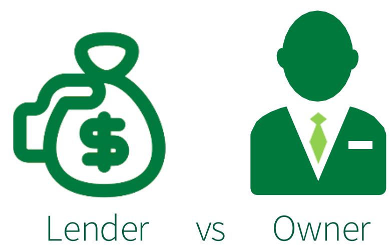
Financial Planning Insights – Understanding Bonds

Timely insights that you can use.

"Gentlemen prefer bonds." – Andrew Mellon (U.S. Secretary of the Treasury, 1921-1932)

Roughly 900 years ago the city-state of Venice started issuing the first known bonds, and over the centuries that followed, bonds have become a major financial instrument. As of February 2025, the size of the bond market within the United States is roughly $46.2 *trillion*[1], not including mortgage-backed and asset-backed securities. Bonds represent the second most common investment instrument, only trailing stocks, and have specific characteristics that may help in the creation of well-designed asset allocations.

In its most basic understanding, a bond owner is lending money to the bond issuer, whereas a stockholder is a partial owner in a company. A bond issuer may have need of capital to finance some project and borrowing money from the public by issuing bonds is one way they can raise that money. The bond will typically have a defined maturity date by which the borrowing entity will repay the loan, making periodic interest payments along the way.



Bonds may also be referred to by the alternate label of *fixed income* in many investment settings. This edition of Financial Planning Insights is meant to provide a basic exposure to bonds and help you understand how fixed income may play a role in many investment strategies.

Let's familiarize ourselves with some basic bond terms and characteristics.

Coupon

A bond's coupon rate is the stated interest rate the issuer promises to pay through its maturity date. It is expressed in annual terms as a percentage of the amount the bond owner will receive at maturity (or the face value).

Current Yield

Because bond values may fluctuate between the date of issue and maturity, the current yield is identified by dividing the annual interest amount the bond pays by its current value. For example, a bond paying $50 of annual interest, but with a market value of $850, will have a current yield of 5.88%.

Yield to Maturity

This is the rate of return on a bond that is held to maturity which factors in the purchase price, the redemption value, the coupon rate, the time between interest payments, and the time remaining until maturity. Maturity is simply that point in time when the "loan comes due" and the principal is to be repaid by the bond issuer.

Par Value

This the nominal or face value of a bond. A bond selling at par is worth the same dollar amount as it was at issue. This is also the amount for which it will be redeemed at maturity. Bonds are typically issued with a $1,000 face (par) value.

1. https://www.sifma.org/resources/research/statistics/us-fixed-income-securities-statistics/#:~:text=Issuance%20(as%20of%20January)%20$985.2,%2C%20+6.3%25%20Y/Y

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Risks when Investing in Bonds

Bonds are generally considered to be less risky or less volatile than stocks. This can make them an effective counterbalance to riskier stock investments. However, that doesn't mean that fixed income investments are entirely free of potential risk. Let's look at some of those potential risks when investing in bonds (or bond funds).

Default Risk

This is the risk that a bond issuer may not be able to make good on the terms of the bond, either to pay the stated interest rate or repay the amount borrowed upon maturity. It reflects the credit worthiness of the bond issuer. Issuers with better prospects of being able to meet the terms of the bond will generally pay a lower interest rate than issuers with poorer financial prospects. Bonds issued by less credit-worthy issuers are often referred to as *high yield* bonds, or even the pejorative moniker, *junk bonds*. It's worth noting that in bankruptcy settings, the claims of bondholders are prioritized over those of stockholders which provides some greater protection in the event that a corporation becomes insolvent.

Interest Rate Risk

Because the amount of interest income paid by a bond is usually fixed for its lifespan, when interest rates in the economy change during that time, it can make that interest income become more or less attractive in relation to newly issued bonds. This means that the price of an individual bond will move inversely with interest rates. If rates move higher, that will make the fixed income paid by an existing bond less attractive, which will drive down the value of that bond. The inverse is also true, if rates drop then the fixed income paid by an existing bond will attract more buyers, driving up its price.

Reinvestment Risk

Because interest rates are seemingly always on the move either up or down, reinvestment risk is the risk that an investor might receive a lower interest rate when reinvesting the bond interest they receive or the bond principal when it is paid back to them. Of course, the opposite is also true. An investor may be able to reinvest those payments into higher interest earning bonds if rates have risen.

Bonds and Income Taxes

The income taxes associated with interest paid by bonds is generally related to who the bond issuer might be. In general, we will break it down into three broad categories: bonds issued by private corporations, bonds issued by the United States government, and bonds issued by state and local governments.

Corporate Bonds

Bonds issued by corporations seeking to raise money for their businesses will pay interest that is subject to ordinary income taxation by both the federal government and most states. If the bond is sold prior to maturity, there may also be a capital gain or loss that is triggered if the price has strayed away from its value at the time it was purchased.

U.S. Government Bonds

Interest received from the various types of U.S. government bonds is taxed as ordinary income on your federal tax return but is typically exempt from taxation by states and municipalities. As with corporate bonds, if U.S. government bonds are sold before maturity, a capital gain or loss will result if the bonds were sold for more or less than the purchase price.

Municipal Bonds

The interest received from many municipal bonds is exempt from federal taxation. It is also generally tax exempt for the jurisdiction issuing the bond when the owner also lives there. While the interest may usually be tax exempt, it is still counted in several formulas, such as determining the alternative minimum tax (AMT), the taxation of Social Security benefits, the level of Medicare premiums one might pay, and even one's ability to contribute to a Roth IRA. As with corporate and U.S. government bonds, if a municipal bond is sold for more or less than its purchase price, a capital gain or loss will result as well as the potential tax consequences associated with such.

Summary

Bonds play an important role in most diversified investment portfolios. They generally pay predictable income, are less volatile than stocks, and offer a way to mitigate some investment risk through their lower correlation with other asset classes. There are many different types of bonds, beyond what have been presented here, and investors may own them directly or as part of a fund that owns bonds as part of its holdings. They can play an appropriate role in the portfolios of all but the most aggressive of investors. You may find COUNTRY Trust Bank's current perspective on bonds in their recent Market and Economic Outlook helpful. Consider discussing with your financial advisor how bonds or bond funds may play a role within your investments and help you achieve your goals and moderate your risk exposure.

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