Chapter 1

So You Want to Be a Bondholder

In This Chapter

- Getting a handle on the nature of bonds
- Knowing why some bonds pay more than others
- Understanding the rationale behind bond investing
- Meeting the major bond issuers
- Considering individual bonds versus bond funds

Long before I ever knew what a bond was (it's essentially an IOU), I lent five dollars to Tommy Potts. This was the first time that I ever lent money to anyone. Tommy was a blond, goofy-looking kid in my seventh-grade class. I can't recall why he needed the five dollars so much, but he was my pal, and he promised to repay me, so I acquiesced.

Weeks went by, and I couldn't get my money back, no matter how much I bellyached. Finally, I decided to go to a higher authority. So I approached Tommy's dad.

I figured that Mr. Potts would give Tommy a stern lecture on the importance of maintaining his credit and good name, and that Mr. Potts would then either make Tommy cough up my money, or he would make restitution himself.

"Er, Mr. Potts," I said, "I lent Tommy five bucks, and . . ."

"You lent *him* money?" Mr. Potts interrupted, pointing his finger at his dead-beat 12-year-old son, who, if I recall correctly, at that point had turned over one of his pet turtles and was spinning it like a top. "Um, yes, Mr. Potts — five dollars." At which point, Mr. Potts neither lectured nor reached for his wallet. Rather, he erupted into savage laughter. "You lent *him* money!" he bellowed repeatedly, laughing, slapping his thighs, and pointing to his turtle-torturing son. "You lent *him* money! *HA* . . . *HA* . . .*HA* . . . *HA* . . ."

And that, dear reader, was my very first experience as a creditor. I never saw a nickel in either interest or returned principal, not to this very day.

Oh, yes, I've learned a lot since then.

Understanding What Makes a Bond a Bond

Now supposing that Tommy Potts, instead of being a goofy kid in the seventh grade, were the United States government. Or the city of Philadelphia. Or Procter & Gamble. Tommy, in his new powerful incarnation, needs to raise not five dollars but $50 million, for whatever reason. So Tommy decides to issue a bond. A bond is really not much more than an IOU with a serial number. People in suits, to sound impressive, sometimes call bonds *debt securities* or *fixed-income securities.*

A bond is always issued with a certain *face amount,* also called the *principal,* also called the *par value* of the bond. Most often, simply because it is convention, bonds are issued with face amounts of $1,000. So in order to raise $50 million, Tommy would have to issue 50,000 bonds each selling at $1,000 par. Of course, he would then have to go out and find investors.

Every bond pays a certain rate of *interest,* and typically (but not always) that rate is fixed over the life of the bond (hence *fixed-income* securities). The life of the bond, in the parlance of financial people, is known as the bond's *maturity.* (The bond world is full of jargon.) The rate of interest is a percentage of the face amount and is typically (again, simply because of convention) paid out twice a year.

So if a corporation or government issues a $1,000 bond, paying 6 percent, that corporation or government promises to fork over to the bondholder $60 a year — or, in most cases, $30 twice a year. Then, when the bond matures, the corporation or government gives the bondholder his or her $1,000 back.

In some cases, you can buy a bond directly from the issuer and sell it back directly to the issuer, but in most cases, bonds are bought and sold through a brokerage house or a bank. Oh, yes, these brokerage houses take a piece of the pie, sometimes a quite sizeable piece — more on that (and how to limit broker gluttony) in Part IV.

So far, so good?

In short, dealing in bonds isn't really all that different from the deal I worked out with Tommy Potts. It's just a bit more formal, the issuance of bonds is regulated by the Securities and Exchange Commission (and other regulatory authorities), and most (but not all) bondholders — unlike me — wind up getting paid back!

Choosing your time frame

Almost all bonds these days are issued with life spans (maturities) of up to 30 years. Few people are interested in loaning their money for longer than that, and people young enough to think more than 30 years ahead rarely have enough money to lend. In the parlance of bond people, any bond with a maturity of less than five years is called a *short bond.* Bonds with maturities of 5 to 12 years are called *intermediate bonds.* Bonds with maturities of 12 years or more are called *long bonds.*

In general (sorry, but you're going to read those words a lot in this book; bond investing comes with few hard-and-fast rules), the longer the maturity, the greater the interest rate paid. That's because bond buyers generally (there I go again) demand more compensation the longer they agree to tie up their money. At the same time, bond issuers are willing to fork over more interest in return for the privilege of holding onto your money longer.

It's exactly the same theory and practice with bank CDs: Typically the two-year CD pays more than the one-year CD, which pays more than the six-month CD.

The difference between the rates you can get on short bonds versus intermediate bonds versus long bonds is known as the *yield curve. Yield* simply refers to the annual interest rate. In Chapter 4, I provide an in-depth discussion of interest rates, bond maturity, and the all-important yield curve.

Determining who you trust to hold your money

Let's consider again the analogy to bank CDs. Both bonds and CDs tend to pay higher rates of interest the longer the time period you're willing to lend your money. But that's where the similarity ends.

When you give your money to a savings bank to plunk into a CD, that money — your principal — is guaranteed (up to $100,000 per account) by the Federal Deposit Insurance Corporation (FDIC). For that reason, all savings bank CDs — all those that carry FDIC insurance — are pretty much the same. You can choose your bank because it is close to your house or because it gives lollipops to your kids, but if solid economics be your guide, you should open your CD where you're going to get the highest rate of interest. End of story.

REMEMBER

Things aren't so simple in the world of bonds. A higher rate of interest isn't always the best deal. When you fork your money over to buy a bond, your principal is guaranteed only by the issuer of the bond, so that guarantee is only as solid as the issuer itself. (Remember my seventh-grade experience?)

That's why U.S. Treasury bonds (guaranteed by the United States government) pay one interest rate, General Electric bonds pay another rate, and General Motors bonds pay yet another rate. Can you guess where you'll get the highest rate of interest?

You would expect the highest rate of interest to be paid by General Motors (currently a somewhat shaky company). Why? Because lending your money to GM involves some risk. If GM were to go bankrupt, you might lose a good chunk of your principal. That risk requires GM to pay a higher rate of interest. Without paying some kind of *risk premium,* the manufacturer of gas-guzzling cars simply would not be able to attract any people to lend it money to make more gas-guzzling cars.

Conversely, the United States government, which has the power to levy taxes and print money (despite the cries of a few anarchistic nutcases) is not going bankrupt any time soon. Therefore, U.S. Treasury bonds, which are said to carry no risk of default, tend to pay relatively modest interest rates.

If Tommy Potts were to come to me for a loan today, needless to say, I wouldn't loan him money. Or if I did, I would require a huge risk premium, along with some kind of collateral (more than his pet turtles). Bonds issued by the likes of Tommy Potts or General Motors — bonds that carry a relatively high risk of default — are commonly called *high-yield* or *junk* bonds. Bonds issued by solid companies and governments that carry very little risk of default are commonly referred to as *investment-grade* bonds.

There are many, many shades of gray in determining the quality and nature of a bond. It's not unlike wine tasting in that regard. In Chapter 4, and again in Chapter 14, I give many specific tips for "tasting" bonds and choosing the finest vintages for your portfolio.

Recognizing the difference between bonds, stocks, and Beanie Babies

Aside from the maturity and the quality of a bond, other factors could weigh heavily in how well a bond purchase treats you. In the following chapters, I introduce you to such bond characteristics as *callability, duration,* and *correlation,* and I explain how the winds of the economy, and even the whims of the bond-buying public, can affect the returns of your bond portfolio.

For the moment, I simply wish to point out that, by and large, bonds' most salient characteristic — and the one thing that most, but not all bonds share — is a certain stability and predictability, well above and beyond that of most other investments. Because you are, in most cases, receiving a steady stream of income, and because you expect to get your principal back in one piece, bonds tend to be more conservative investments than, say, stocks, commodities, or collectibles.

The bond market is HUMONGOUS

How much is invested in bonds worldwide? Are you holding onto your seat? According to 2006 figures compiled by the Securities Industry and Financial Markets Association, the total value of all bonds outstanding worldwide is now slightly over $61 *trillion.* That's equal to about five times the current gross domestic product of the United States — the dollar value of all goods and services produced in this country in an entire year.

Given that the stock market gets so much more attention than the bond market, you may be surprised to know that the total value of all stocks outstanding worldwide is a mere $50 trillion.

Is conservative a good thing? Not necessarily. It's true that many people (men, mostly) invest their money too aggressively, just as many people (women, mostly) invest their money too conservatively. The appropriate portfolio formula depends on what your individual investment goals are. I help you to figure that out in Chapters 12 and 13.

By the way, these are not my personal gender stereotypes. Some solid research shows that males of the human species do tend to invest (and drive) much more aggressively than do women.

Why Hold Bonds? (Hint: You'll Likely Make Money!)

In the real world, plenty of people own plenty of bonds — but often the wrong bonds in the wrong amounts and for the wrong reasons. Some people have too many bonds, making their portfolios too conservative; some have too few bonds, making their portfolios too volatile; some have taxable bonds where they should have tax-free bonds; others have tax-free where they should have taxable bonds. Others are so far out on the limb with shaky bonds that they may as well be lending money to Tommy Potts.

The first step in building a bond portfolio is having clear investment objectives. (Although I hear it from clients all the time, "I want to make money" is *not* a clear investment objective!) I help you to develop clear objectives in Chapter 2. In the meantime, I want you to consider some of the typical reasons people buy and hold bonds . . . both good and bad.

Identifying the best reason to buy bonds: Diversification

Most people buy bonds because they perceive a need for steady income, and they think of bonds as the best way to get income without risking principal. This is one of the most common mistakes investors make: compartmentalization. They think of principal and interest as two separate and distinct money pools. They are not.

Let me explain: Joe Typical buys a bond for $1,000. At the end of six months, he collects an interest payment (income) of, say, $25. He spends the $25, figuring that his principal (the $1,000) is left intact to continue earning money. At the same time, Joe buys a stock for $1,000. At the end of six months, the price of his stock, and therefore the value of his investment, has grown to, say, $1,025. Does he spend the $25? No way. Joe reckons that spending any part of the $1,025 is spending principal and will reduce the amount of money he has left working for him.

In truth, whether Joe spends his "interest" or his "principal," whether he spends his "income" or generates "cash flow" from the sale of stock, he is left with the *very same* $1,000 in his portfolio.

Thinking of bonds, or bond funds, as the best — or only — source of cash flow or income can be a mistake.

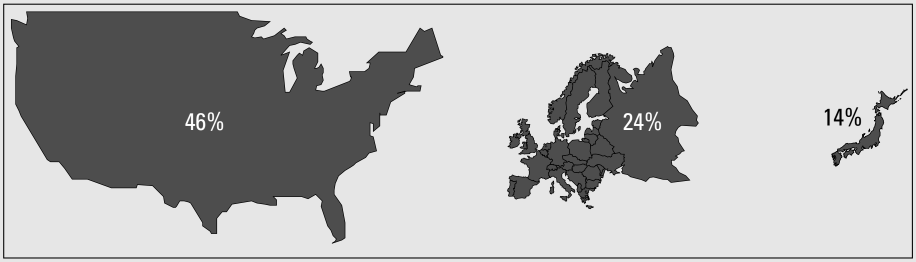
Bonds are a better source of steady income than stocks because bonds, in theory (and usually in practice), always pay interest; stocks may or may not pay dividends and may or may not appreciate in price. Bonds also may be a logical choice for people who may need a certain sum of money at a certain point in the future — such as college tuition or cash for a new home — and can't risk a loss.

But unless you absolutely need a steady source of income, or a certain sum at a certain date, bonds may not be such a hot investment because over the long haul, they tend to return much less than stocks. I revisit this issue, and talk much more of the differences between stocks and bonds, in Chapter 12.

For now, the point I wish to make is that the far better reason to own bonds, for most people, is to *diversify* a portfolio. Bonds tend to zig when stocks zag. The key to truly successful investing, as I outline in Chapter 11, is to have at least several different *asset classes* — different investment animals with different characteristics — all of which can be expected to yield positive long-term return, but which do not all move up and down at the same time.

Bond map of the world: Where are most bonds issued?

Approximately 84 percent of all the world's bonds created in 2006 were issued in the United States, Europe, or Japan.



Source: Securities Industry and Financial Markets Association

Going for the cash

Bonds are not very popular with the get-rich-quick crowd — for good reason. The only people who get rich off bonds are generally the insiders who trade huge amounts and can clip the little guy. Nonetheless, certain categories of bonds — high-yield corporate bonds, for example — have been known to produce impressive gains.

High-yield bonds may have a role — a limited role — in your portfolio, as I discuss in Chapter 6. But know up front that high-yield bonds do not offer the potential long-run return of stocks, and neither do they offer the portfolio protection of investment-grade bonds. Rather than zigging when the stock market zags, many high-yield bonds zag right along with your stock portfolio. Be careful!

There are some high-yield bonds that I prefer over others — bonds that are held by few people. I recommend those in Chapter 9.

Even high quality, investment-grade bonds are often purchased with the wrong intentions. Note: The safest bond of all, a U.S. Treasury bond, *will not guarantee your return of principal unless you hold it to maturity.* In other words, if you buy a 20-year bond and you want to know for sure that you're going to get your principal back, you had better plan to hold it for 20 years. If you sell it before it is fully ripe, you may lose a bundle. Bond prices, especially on long-term bonds — yes, even Uncle Sam's bonds — can fluctuate greatly! I discuss the reasons for this fluctuation in Chapter 4.

I also discuss the very complicated and often misunderstood concept of bond returns. You may buy a 20-year U.S. Treasury bond yielding 6 percent, and you may hold it for 20 years, to full maturity. And yes, you'll get your principal back, but you may actually get far more or far less than 6 percent interest on your money! It's complicated, but I explain this variation in a way you can understand — I promise! — in Chapter 4.

Introducing the Major Players in the Bond Market

Every year, millions — yes, literally millions — of bonds are issued by thousands of different governments, government agencies, municipalities, financial institutions, and corporations. They all pay interest. In many cases, the interest rates aren't all that much different from each other. In most cases, the risk of the issuer *defaulting* — not paying back your principal — is minute. So why, as a lender of money, would you want to choose one type of issuer over another?

Glad you asked!

Following are some important considerations about each of the major kinds of bonds, categorized by who issues them. I'm just going to scratch the surface right now. For a more in-depth discussion, see the five chapters in Part II.

Supporting (enabling?) your Uncle Sam with Treasury bonds

Politicians like raising money by selling bonds, as opposed to raising taxes, because voters hate taxes. Of course, when the government issues bonds, it promises to repay the bond buyers over time. The more bonds the government issues, the greater its debt. Voters don't seem to care much about debt.

The current debt of the United States government is slightly more than $8.6 trillion: almost $30,000 per every man, woman, and child.

The interest payments on that debt, combined with the steady repayment of principal, are an enormous burden. Of every dollar spent by the U.S. government in 2006, approximately eight cents went to the interest payments on Treasury bonds. In my mind, that's a bit too much cash, but this is not a political book, so I'm not going to tell you how to vote. (Not that you would listen to me anyway.) From here on, I address only the role that Treasury bonds may play in your portfolio.

In Chapter 5, I explain all the many, many kinds of Treasury bonds — from EE Bonds to I Bonds to TIPS — and the unique characteristics of each. For the moment, I merely wish to point out that all of them are backed by the “full faith and credit” of the federal government. Despite its huge debt, the United States of America is not going bankrupt any time soon. And for that reason, Treasury bonds are often referred to as “risk-free.” Careful! That does *not* mean that the price of Treasury bonds does not fluctuate.

REMEMBER

When bonds experts speak of Treasury bonds as having no risk, what they mean is that the bonds have no *credit* risk. But Treasury bonds are very much subject to the other kinds of risk that most other bonds are subject to: interest rate risk, inflation risk, and reinvestment risk. I discuss these risks in Chapter 10.

Collecting corporate debt

Bonds issued by for-profit companies are riskier than government bonds but tend to compensate for that added risk by paying higher rates of interest. (If they didn’t pay higher rates of interest, why would you or anyone else want to take the extra risk?) In recent history, corporate bonds in the aggregate have tended to pay about a percentage point higher than Treasuries of similar maturity.

TIP

As you’ll discover, I am a huge fan of diversification. It is especially important to diversify when dealing with riskier investments. For that reason, I hate to see anyone plunk too great a percentage of his or her portfolio into any individual corporate bond. Wealthier investors — those with portfolios of $1 million or more — can diversify by buying a collection of bonds. Savvy investors can temper their risks by familiarizing themselves with bond ratings and researching the issuing companies’ bottom lines. But I generally advocate bond ownership — especially where it comes to corporate bonds — in bond funds. I discuss these funds at the end of this chapter and again, in greater depth, in Chapter 16.

Oh, one more little thing about corporate bonds for the moment: They tend to get *called* a lot. That means that the corporation changes its incorporated mind about wanting your money and suddenly throws it back at you, canceling the bond. Bond calls can be no fun! They add a heavy dose of unpredictability to what should be a predictable investment. Read all about calls and other peculiarities of the corporate bond world in Chapter 6.

Demystifying those quasi-governmental agencies

Federal agencies such as Federal Home Loan Mortgage Corporation (Freddie Mac), Federal National Mortgage Association (Fannie Mae), and Small Business Administration issue a good chunk of the bonds on the market — together, about 18 percent of the bonds held by individual households. Such agencies aren't quite government and aren't quite private concerns. They are government "sponsored," and in theory, Congress and the Treasury would serve as protective big brothers if one of these agencies were to take a financial beating and couldn't pay off its debt obligations.

Because of their quasi-governmental status, agencies' bond offerings are generally considered the next-safest thing to Treasury bonds. As such, the interest paid on these bonds is typically just a smidgen higher than the interest rate you would get on Treasuries of similar maturity.

I discuss federal agency bonds — the traditional kind of bonds these agencies offer — in Chapter 7. Some bonds issued or guaranteed by the federal agencies are distinctly nontraditional in that they represent an ownership interest in pools of mortgages. These are more complicated than traditional bonds, and I'm sorry to say that many people who invest in them haven't the foggiest idea what they're investing in. More about these babies in Chapter 9.

Going cosmopolitan with municipal offerings

The bond market, unlike the stock market, is overwhelmingly institutional. In other words, the vast majority of bonds are held by insurance companies, pension funds, endowment funds, and mutual funds. The only exception is the municipal bond market.

Municipal bonds (*munis*) are issued by cities, states, and counties. They are used to raise money either for general day-to-day needs of the citizenry (schools, roads, sewer systems) or for specific projects (a new bridge, a sports stadium).

Munis' popularity with individual investors may be due in small part to the warm and fuzzy feelings to be had by investing in local infrastructure. But my guess is that their popularity comes much more from their special tax status.

The household bond market pie

Among the kinds of traditional bonds most popular with individual investors in the United States are Treasuries, corporate bonds, bonds issued by federal agencies, and municipal bonds. According to the Securities Industry and Financial Markets Association and the United States Treasury, as of 2006, U.S. households held more than $15 trillion of these four kinds of bonds alone:

- $5.2 trillion in corporate bonds (see Chapter 6)
- $4.9 trillion in Treasuries (see Chapter 5)
- $2.8 trillion in agency bonds (see Chapter 7)
- $2.3 trillion in municipal bonds (see Chapter 8)

Interest on most municipal bonds is exempt from federal income tax. And even though the interest rates paid are modest, many individual investors, especially those in the higher tax brackets, can often get a better after-tax return on municipal bonds than on comparable taxable bonds.

Like corporate bonds, but unlike Treasuries, municipal bonds are often subject to call. You may *think* you're buying a ten-year investment, but you may be forced to relinquish the bond in two years. (Bond brokers often fail to advertise this fact to buyers.)

Municipal bonds tend to be less risky than corporate bonds but not as safe as Treasuries and agency bonds. Just as corporate bonds are given ratings, so are municipal bonds. It's important to know before investing whether the local government issuing the bond has the wherewithal to pay back your principal. Cities don't go bankrupt often, but it does happen. I reveal much, much more on munis in Chapter 8.

Buying Solo or Buying Bulk

One of the big questions about bond investing that I help you to answer later in this book is whether to invest in individual bonds or bond funds.

I'm a big advocate of bond funds — both bond mutual funds and exchange-traded funds. Mutual funds and exchange-traded funds both represent baskets of securities (usually stocks or bonds, or both) and allow for instant and easy portfolio diversification.

I outline the pros and cons of owning individual bonds versus bond funds in Chapter 14. Here, I give you a very quick sneak preview of that discussion.

Picking and choosing individual bonds

Individual bonds offer investors the opportunity to really fine-tune a fixed-income portfolio. With individual bonds, you can choose exactly what you want in terms of bond quality, maturity, and taxability.

For larger investors — especially those doing their homework — investing in individual bonds may also be more economical than investing in a bond fund. That's especially true for those investors up on the latest advances in bond buying and selling.

Once upon a time, any buyer or seller of individual bonds had to take a giant leap of faith that his or her bond broker wasn't trimming too much meat off the bone. No more. In Chapter 15, I show you how to find out exactly how much your bond broker is making off you — or trying to make off you. I show you how to compare comparable bonds to get the best deals. And I discuss some popular bond strategies, including the most popular and potent one, *laddering* your bonds, which means staggering the maturities of the bonds you buy.

Going with a bond fund or funds

Investors now have a choice of more than 5,000 bond mutual funds or exchange-traded funds. All have the same basic drawback: management expenses. But even so, some make for very good potential investments, particularly for people with modest portfolios.

Where to begin your fund search? I promise to help you weed out the losers and pick the very best. As you'll discover (or as you know already if you have read my *Exchange-Traded Funds For Dummies*), I'm a strong proponent of buying *index funds* — mutual funds or exchange-traded funds that seek to provide exposure to an entire asset class (such as bonds or stocks) with very little trading and very low expenses. I believe that such funds are the way to go for most investors to get the bond exposure they need. I suggest some good bond index funds, as well as other bond funds, in Chapter 16.

If you would like to know more about funds in general, I would advise you to pick up copies of *Exchange-Traded Funds For Dummies* and the latest edition of Eric Tyson's *Mutual Funds For Dummies,* both published by Wiley.