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 is (it's essentially an IOU), I agreed to lend five dollars to Tommy Potts, a blond, goofy-looking kid in my seventh-grade class. This was the first time that I'd ever lent money to anyone. I can't recall why Tommy needed the five dollars, but he did promise to repay me, and he was my pal.

Weeks went by, then months, and I couldn't get my money back from Tommy, 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. Then, Mr. Potts would 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 mocking 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* . . ."

And that, dear reader, was my very first experience as a creditor. I never saw a nickel from Tommy, in either interest or returned principal.

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

Understanding What Makes a Bond a Bond

Now suppose that Tommy Potts, instead of being a goofy kid in the seventh grade, were the U. S. government. Or the city of Philadelphia. Or Procter & Gamble. Tommy, in his powerful new incarnation, needs to raise not five dollars but $50 million. 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 specific *face amount,* also called the *principal,* or *par value.* 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 to buy his bonds.

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 is the period of time until maturity. Maturity, in the lingo of financial people, is the period of time until the principal is due to be paid back. (Yes, 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 interest, 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 repays the $1,000 to the bondholder.

In some cases, you can buy a bond directly from the issuer and sell it back directly to the issuer. But you're more likely to buy a bond through a brokerage house or a bank. You can also buy a basket of bonds through a company that sells mutual funds or exchange-traded funds. These brokerage houses and fund companies will most certainly take a piece of the pie — sometimes a quite sizeable piece. More on that (and how to limit broker and fund-manager 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. And the entire business is regulated by the Securities and Exchange Commission (among 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 lending their money for longer than that, and people young enough to think more than 30 years ahead rarely have enough money to lend. In bond lingo, bonds with a maturity of less than five years are typically referred to as *short-term bonds.* Bonds with maturities of 5 to 12 years are called *intermediate-term bonds.* Bonds with maturities of 12 years or longer are called *long-term 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 (Certificates of Deposit): Typically a two-year CD pays more than a one-year CD, which in turn pays more than a six-month CD.

The different rates that are paid on short, intermediate, and long bonds make up what 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.

Picking who you trust to hold your money

Let's consider again the analogy between bonds and bank CDs. Both tend to pay higher rates of interest if you're willing to tie up your money for a longer period of time. 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 almost certainly guaranteed (up to $250,000 per account) by the Federal Deposit Insurance Corporation (FDIC). 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 FDIC insurance (almost all banks carry it) and 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 over your money to buy a bond, your principal, in most cases, is guaranteed only by the issuer of the bond. 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 U.S. government) pay one interest rate, General Electric bonds pay another rate, Sprint

Nextel 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 Sprint Nextel (currently a somewhat shaky company). Why? Because lending your money to Sprint involves the risk that your money may sprint off into oblivion. In other words, if the company goes belly up, you may lose a good chunk of your principal. That risk requires any shaky company to pay a relatively high rate of interest. Without being paid some kind of *risk premium,* you would be unlikely to lend your money to a company that may not be able to pay you back. Conversely, the U.S. government, which has the power to levy taxes and print money, is not going bankrupt any time soon. Therefore, U.S. Treasury bonds, which are said to carry only an infinitely small 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 lend 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 Sprint Nextel — 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 on 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 the latest figures compiled by the Securities Industry and Financial Markets Association, the total value of all bonds outstanding worldwide is now slightly over $95 *trillion.* That's equal to about six 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 $55 trillion.

Is conservative a good thing? Not necessarily. It's true that many people (men, more often than women) invest their money too aggressively, just as many people (of both genders) 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, my comment about men investing more aggressively is not my personal take on the subject. Some solid research shows that men do tend to invest (as they 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 stock-heavy portfolios too volatile. Some have taxable bonds where they should have tax-free bonds, and vice versa. Others are so far out on a limb with shaky bonds that they may as well be lending their money to Tommy Potts.

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

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.

REMEMBER

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 on a certain date, bonds may not be such a hot investment. Over the long haul, they have tended to return much less than stocks. I revisit this issue, and talk much more about the differences between stocks and bonds, in Chapter 12.

TIP

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. Simply put, bonds tend to zig when stocks zag, and vice versa. 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 returns, but that do not all move up and down together.

Bond map of the world

More than half of the world's bonds created in 2009 were issued in the United States (35 percent), Japan (13 percent), or the United Kingdom (5 percent). The percentages reflected in this figure were provided by the Securities Industry and Financial Markets Association and the Bank of International Settlement.

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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 (junk) bonds, for example — have been known to produce impressive gains.

High-yield bonds may have a role — a limited one — in your portfolio, as I discuss in Chapter 6. But know up front that high-yield bonds do not offer the potential long-term returns 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!

Some high-yield bonds are better than others — and they are held by relatively few people. I recommend those in Chapter 9.

Even high quality, investment-grade bonds are often purchased with the wrong intentions. Note: A U.S. Treasury bond, though generally thought to be the safest bond of all, *will not guarantee your return of principal unless you hold it to maturity.* 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 matures, 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 3 percent, and you may hold it for 20 years, to full maturity. And yes, you'll get your principal back, but you may actually earn far more or far less than 3 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 that the issuer will *default* — fail to pay 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 may groan about the national debt, but they generally don't see it as an immediate problem.

The current debt of the United States government is slightly more than $15 trillion: almost $50,000 for every U.S. citizen. (Yikes! The figures in the first edition of this book, written only a few years ago, were $8.6 trillion and $30,000 per citizen.)

The interest payments on that debt are an enormous burden, currently totaling more than $450 billion a year. 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 of 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 anytime soon. And for that reason, Treasury bonds have traditionally been referred to as "risk-free." Careful! That does *not* mean that the prices of Treasury bonds do not fluctuate.

When bond experts speak of Treasury bonds as having no risk, or almost 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 beset most other bonds: interest rate risk, inflation risk, and reinvestment risk. I discuss these types of risk 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, why would you or anyone else want to take the extra risk?) For the past few decades, corporate bonds in the aggregate have tended to pay about a percentage point higher than Treasuries of similar maturity. Since 2008, this spread has broadened, with ten-year corporate bonds paying about a percentage point and a half more than their governmental counterparts.

As you'll discover, I am a big fan of diversification. It is especially important to diversify when dealing with riskier investments. For that reason, I don't like to see people plunk too great a percentage of their portfolios 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 when 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 tend to happen when rates have fallen, and that's 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 government and government-like agencies

Federal agencies, such as the Government National Mortgage Association (Ginnie Mae), and government-sponsored enterprises (GSEs), such as the Federal Home Loan Banks, issue a good chunk of the bonds on the market. Even though these bonds can differ quite a bit, they are collectively referred to as *agency* bonds. What we call agencies are sometimes part of the actual government, and sometimes a cross between government and private industry. In the case of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), they have been, following the mortgage crisis of 2008, somewhat in limbo.

To varying degrees, Congress and the Treasury will serve as protective big brothers if one of these agencies or GSEs were to take a financial beating and couldn't pay off its debt obligations.

In general, agency bonds are 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, although in very recent times, you can get a smidgen-plus.

I discuss 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 — although some found out the hard way in late 2007 and 2008, when some of these mortgage bonds took a serious hit. More about these babies in Chapter 7, as well.

Going cosmopolitan with municipal bonds

The bond market, unlike the stock market, is overwhelmingly institutional. In other words, most 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 for either the 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 U.S. bond market pie

The U.S. Treasury has more bonds outstanding than does corporate America, and corporate bonds in the aggregate are worth more than municipal bonds. Here are a few of the largest segments of the U.S. bond market and how they compare in total dollar value. The numbers are according to the Securities Industry and Financial Markets Association (SIFMA).

Types of Bonds Outstanding (in trillions), 2011:

- Treasury bonds: $10.0 (see Chapter 5)
- Corporate bonds: $7.7 (see Chapter 6)
- Municipal bonds: $2.9 (see Chapter 8)
- Federal agency bonds: $2.4 (see Chapter 7)

REMEMBER

Interest on most municipal bonds is exempt from federal income tax. Traditionally, the interest rates paid have been modest, but many individual investors — especially those in the higher tax brackets — could often get a better after-tax return on municipal bonds than on comparable taxable bonds. In recent years, municipals have tended to yield more than Treasuries — even on a before-tax basis.

Like corporate bonds, but unlike Treasuries, municipal bonds are often subject to being called. You may *think* you're buying a ten-year investment, but you may be forced to relinquish the bond in two years instead. (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 Treasury 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 a bond has the wherewithal to pay back your principal. Cities don't go bankrupt often, but it does happen. And lately, some pundits have expressed fears that in the future, more municipalities than ever may declare bankruptcy. (That fear is part of what has driven up the yield on these bonds.) I reveal much, much more on munis in Chapter 8.

Buying Solo or Buying in 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 generally advocate bond funds — both bond mutual funds and exchange-traded funds. Mutual funds and exchange-traded funds represent baskets of securities (usually stocks or bonds, or sometimes both) and allow for instant and easy portfolio diversification. You do, however, need to be careful about which funds you choose. Not all are created equal — far, far from it.

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

Once upon a time, any buyers or sellers of individual bonds had to take a giant leap of faith that their 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 that you buy.

Going with a bond fund or funds

Investors now have a choice of well over 5,000 bond mutual funds or exchange-traded funds. All have the same basic drawbacks: management expenses and a certain degree of unpredictability above and beyond individual bonds. 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 the latest editions of *Exchange-Traded Funds For Dummies* and Eric Tyson's *Mutual Funds For Dummies,* both published by Wiley.