Chapter 1

The Bond Fundamentals

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 deadbeat 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 4-percent interest, that corporation or government promises to fork over to the bondholder $40 a year — or, in most cases, $20 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.

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 2, 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). 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.

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. That's why U.S. Treasury bonds (guaranteed by the U.S. government) pay one interest rate, General Electric bonds pay another rate, and RadioShack 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 RadioShack. Why? Because lending your money to RadioShack, which has been busy closing stores left and right, involves the risk that company HQ may close, as well.. 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 RadioShack — 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 2, and again in Chapter 11, I give many specific tips for "tasting" bonds and choosing the finest vintages for your portfolio.

Differentiating among 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.

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 Chapter 10.

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!) Here are 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.

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 tend to return much less than stocks. I revisit this issue, and talk much more about the differences between stocks and bonds, in Chapter 10.

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 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.

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 3. 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 3.

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 2.

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 phenomenon in Chapter 2.

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 Chapter 3. In the meantime, here are the basics:

- **Supporting (enabling?) your Uncle Sam with Treasury bonds:** 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.

  In Chapter 3, 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 want 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.
- **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 third more than their governmental counterparts.
- **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.

- **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).

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 11. 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 4, 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 5.

The Triumphs and Failures of Fixed-Income Investing

Picture yourself in the year 1926. Calvin Coolidge occupies the White House. Ford's Model T can be bought for $200. Charles Lindbergh is gearing up to fly across the Atlantic. And you, having just arrived from your journey back in time, brush the time-travel dust off your shoulders and reach into your pocket. You figure that if you invest $100, you can then return to the present, cash in on your investment, and live like a corrupt king. So you plunk down the $100 into some long-term government bonds.

Fast-forward to the present, and you discover that your original investment of $100 is now worth $11,730. It grew at an average annual compound rate of return of 5.5 percent. (In fact, that's just what happened in the real world.) Even though you aren't rich, $11,730 doesn't sound too shabby. But you need to look at the whole picture.

Beating inflation, but not by very much

REMEMBER

Yes, you enjoyed a return of 5.5 percent a year, but while your bonds were making money, inflation was eating it away . . . at a rate of about 3.0 percent a year. What that means is that your $11,730 is really worth about $885 in 1926 dollars.

To put that another way, your real (after-inflation) yearly rate of return for long-term government bonds was about 2.5 percent. In about half of the 89 years, your bond investment either didn't grow at all in real dollar terms, or actually lost money.

Compare that scenario to an investment in stocks. Had you invested the very same $100 in 1926 in the S&P 500 (500 of the largest U.S. company stocks), your investment would have grown to $567,756 in *nominal* (pre-inflation) dollars. In 1926 dollars, that would be about $42,800. The average nominal return was 10.2 percent, and the average real annual rate of return for the bundle of stocks was 7.0 percent. (Those rates ignore both income taxes and the fact that you can't invest directly in an index, but they are still valid for comparison purposes.)

So? Which would you rather have invested in: stocks or bonds? Obviously, stocks were the way to go. In comparison, bonds seem to have failed to provide adequate return.

Saving the day when the day needed saving

But hold on! There's another side to the story! Yes, stocks clobbered bonds over the course of the last eight or nine decades. But who makes an investment and leaves it untouched for that long? Rip Van Winkle, maybe? But outside of fairy tale characters, no one! Real people in the real world usually invest for much shorter periods. And there have been some shorter periods over the past eight or nine decades when stocks have taken some stomach-wrenching falls.

The worst of all falls, of course, was during the Great Depression that began with the stock market crash of 1929. Any money that your grandparents may have had in the stock market in 1929 was worth not even half as much four years later. Over the next decade, stock prices would go up and down, but Grandma and Grandpa wouldn't see their $100 back until about 1943. Had they planned to retire in that period, well . . . they may have had to sell a few apples on the street just to make ends meet.

A bond portfolio, however, would have helped enormously. Had Grandma and Grandpa had a diversified portfolio of, say, 70 percent stocks and 30 percent long-term government bonds, they would have been pinched by the Great Depression but not destroyed. While $70 of stock in 1929 was worth only $33 four years later, $30 in long-term government bonds would have been worth $47. All told, instead of having a $100 all-stock portfolio fall to $46, their 70/30 diversified portfolio would have fallen only to $80. Big difference.

Closer to our present time, a $10,000 investment in the S&P 500 at the beginning of 2000 was worth only $5,800 after three years of a growly bear market. But during those same three years, long-term U.S. government bonds soared. A $10,000 70/30 (stock/bond) portfolio during those three years would have been worth $8,210 at the end. Another big difference.

In 2008, as you're well aware, stocks took a big nosedive. The S&P 500 tumbled 37 percent in that dismal calendar year. And long-term U.S. government bonds? Once again, our fixed-income friends came to the rescue, rising nearly 26 percent. In fact, nearly every investment imaginable, including all the traditional stock-market hedges, from real estate to commodities to foreign equities, fell hard that year. Treasury bonds, however, continued to stand tall.

Clearly, long-term government bonds can, and often do, rise to the challenge during times of economic turmoil. Why are bad times often good for many bonds? Bonds have historically been a best friend to investors at those times when investors have most needed a friend. Given that bonds have saved numerous stock investors from impoverishment, bond investing in the past eight to nine decades may be seen not as a miserable failure but as a huge success.

Gleaning some important lessons

Bonds have been a bulwark of portfolios throughout much of modern history, but that's not to say that money — some serious money — hasn't been lost. In this section, I offer examples of some bonds that haven't fared well so you're aware that even these relatively safe investment vehicles carry some risk.

Corporate bonds

Corporate bonds — generally considered the most risky kind of bonds — did not become popular in the United States until after the Civil War, when many railroads, experiencing a major building boom, had a sudden need for capital. During a depression in the early to mid 1890s, a good number of those railroads went bankrupt, taking many bondholders down with them. Estimates indicate that more than one out of every three dollars invested in the U.S. bond market was lost. Thank goodness we haven't seen anything like that since (although during the Great Depression of the 1930s, plenty of companies of all sorts went under, and many corporate bondholders again took it on the chin).

In more recent years, the global bond default rate has been less than 1 percent a year. Still, that equates to several dozen companies a year. In recent years, a number of airlines (Delta, Northwest), energy companies (Enron), and one auto parts company (Delphi) defaulted on their bonds. Both General Motors and Ford, as well as RadioShack experienced big downgrades (from *investment-grade* to *speculative-grade,* terms I explain in Chapter 2), costing bondholders (especially those who needed to cash out holdings) many millions.

Lehman Brothers, the fourth largest investment bank in the United States, went belly up in the financial crisis of 2008. Billions were lost by those in possession of Lehman Brothers bonds. (Many more billions were also lost in mortgage-backed securities and collateralized debt obligations. These investments are debt instruments issued by financial corporations, but they are very different animals than typical corporate bonds and rarely spoken of in the same breath. I'll get to those in Chapter 5.) Most recently, we've witnessed the collapse of once very healthy corporations, from Borders to Sharper Image to Kodak. Even Hostess became little more than crumbs. (It's tough to imagine that with our insatiable appetite for sugary snacks, a company could lose money on Ding Dongs and Twinkies!) As we've seen time and time again, corporations sometimes go under. None are too big to fail.

Municipal bonds

Municipal bonds, although much safer overall than typical corporate bonds, have also seen a few defaults. In 1978, Cleveland became the first major U.S. city to default on its bonds since the Great Depression. Three years prior, New York City likely would have defaulted on its bonds had the federal government not come to the rescue.

The largest default in the history of the municipal bond market occurred in 2013, when Detroit declared bankruptcy, leaving holders of more than $8 billion in bonds wondering (and, at the time of this writing, they are wondering still) if they will ever their money back.

Largely due to the situation in Detroit, there has been lots of talk about municipal bankruptcies of late. Yet not many have occurred. In recent years, the number of municipalities defaulting on their bonds has been estimated to run about 6/10 of one percent.

Several budget-challenged cities and counties have had to make the difficult choice between paying off bondholders or making good on pension obligations for retired police, firefighters, and teachers. Thus far, the retired workers have suffered more financial pain than the bondholders, perhaps because they have less political clout — and no one wants to alienate bondholders, who may provide much-needed cash in the future.

Sovereign bonds

Nations worldwide also issue government bonds. These are often called *sovereign* bonds. The largest default of all time occurred in 1917 as revolutionaries in Russia were attempting to free the people by breaking the bonds, so to speak, of imperialist oppression. Bonds were broken, for sure; with the collapse of the czarist regime, billions and billions of rubles-worth of Russian bonds were suddenly worth less than non-alcoholic vodka. Most had been sold to Western Europeans. In France, the Parisian government urged people to reject the new Bolshevik regime and show their support of the monarch in Moscow by purchasing Russian bonds. About half of all French households held at least some Russian debt.

Sometimes history can repeat itself or, at least, create echoes of the past. In 1998, one of the largest bond defaults of the modern era occurred once again in Moscow. The Russian government, facing a collapse of its currency, stopped payment on about $40 billion of bonds. And in 2002, Argentina's financial decline forced bondholders to accept 25 cents on the dollar for its outstanding debt of $90 billion.

REMEMBER

As I discuss in Chapter 3, bonds of *emerging-market* nations, such as Russia, Argentina, Mexico, and Turkmenistan, have been one of the hottest investment sectors in the past several years. The returns of late have been impressive, but how quickly people forget the past! Those bonds can be very volatile, and investing in them means risking your principal.

Indeed, the recent global awareness of serious debt problems in several European nations has resulted in fears that even these developed nations (which presumably have already emerged) could default on their bond obligations. This fear has caused their bond prices to drop dramatically and yields to rise sharply. At the time of this writing, while ten-year

U.S. Treasury bonds are yielding about 2 percent, a ten-year bond issued by the Greek government is yielding 27 percent! Clearly, the collective wisdom of the bond market sees the government of Greece as very likely to default.

Realizing How Crucial Bonds Are Today

I could talk about the importance of corporate debt to the growth of the economy, the way in which municipal bonds help to repair roads and build bridges, and how Ginnie Mae and Fannie Mae bonds help to provide housing to the masses, but I think I'll just let this one sentence suffice. This is, after all, not a book on macroeconomics and social policy but a book on personal investing. So allow me to address the crucial role that bonds play in the lives of individual investors — people like you and me.

With approximately $15 trillion invested in bonds, U.S. households' economic welfare is closely tied to the fortunes of the bond market.

REMEMBER

I would argue that with the demise of the traditional pension, bond investing is more important than ever. Back when you knew your company would take care of you in old age, you may have played footloose and fancy free with your portfolio without having to worry that a scrambled nest egg might mean you couldn't afford to buy eggs. Today, a well-tuned portfolio — that almost certainly includes a good helping of bonds — can make the difference between living on Easy Street and living *on* the street.

Keep in mind that most of the money in the $40 trillion U.S. bond market is institutional money. Should you have a life insurance policy, chances are that your life insurance company has most of your future payoff invested in bonds. Should you have money in your state's prepaid college tuition program, chances are that your money is similarly indirectly invested in bonds. Should you be one of the fortunate persons whose company still offers a pension, chances are that your company has your future pension payout invested in bonds.

In total, nearly $90 trillion is invested in bonds worldwide. Many economists speculate that as the Boomer generation continues to move into retirement, the demand for income-generating investments like bonds will only grow. If you live and work in a developed nation, your economic well-being is much more closely tied to the bond markets than you think.

Viewing Recent Developments, Largely for the Better

As the price of everything from groceries and gas to college tuition and medical care continues to climb, it's nice to know that at least two things on this planet have gotten cheaper in the past few years: computers and bond trades. And, as any seasoned bond investor will tell you, saving money on trades isn't the only exciting development of late. Here are some others worth noting:

- **New and better bond funds:** According to Morningstar, you have almost 2,300 bond funds in which to invest. (If I were to include various "classes" of these funds, such as many mutual-fund companies offer, basically for small investors and large investors, the number would be about 10,000.) Of these, at least 300 are bond *index funds* — funds that seek to capture the returns of an entire swatch of the bond market — which, from my vantage point, tend to be the best options for most bond investors. These funds carry an average yearly expense ratio of 28 basis points (28/100 of 1 percent), which is way, way less than most bond funds (the overall average of just about1 percent).

  The newest kid on the block, *exchange-traded funds* (ETFs) — funds similar to mutual funds — are the greatest thing to happen to bond investing in a very long time. ETFs, the vast majority of which are index funds, allow small investors to invest like the Big Boys, with extremely low expenses and no minimum investment requirements. As of this printing, approximately 260 bond ETFs exist. Some of them, such as several offerings from Vanguard and Schwab, carry annual expense ratios of less than 1/10 of one percent.

I discuss both ETFs and mutual funds in Chapter 5.

- **Greater access to information:** One of the advantages of all index funds, but especially exchange-traded funds over traditional actively managed mutual funds, is their relative *transparency.* That means that when you invest in an ETF, you know exactly what you're buying. Traditional mutual funds are not required to reveal their specific investments; you may think you're buying one thing and end up with another.

  When it comes to buying and selling individual bonds, it's as if a muddy pond has been transformed into a glass aquarium. Not long ago, a bond broker would give you a price for a bond, and you'd have absolutely no idea how fair a deal you were getting. Nowadays, you can search online and usually get a very good idea of how fair a deal you're getting, how much the broker is making, and whether better deals can be had. I give you a complete tour of the aquarium in Chapter 4.

- **The expansion of Uncle Sam's treasury chest:** If you are going to invest in individual bonds, U.S. Treasury bonds may make the most sense. The Treasury has a website, `www.treasurydirect.gov`, where you can buy its bonds directly and not have to deal with any brokers whatsoever, nor will you need to fork over any kind of markup. I walk you through the process in Chapter 3.

  TIP

  One special kind of Treasury bond — Treasury Inflation-Protected Securities, or TIPS — has been in existence since the mid-1990s. It is a very exciting development in the world of bonds. TIPS offer only very modest interest rates, but the principal is readjusted twice annually to keep up with inflation. TIPS represent an entirely new *asset class* (kind of investment), and I advocate that most of my clients hold at least one-quarter of their bond allocation in TIPS. They can be important portfolio diversifiers. Read all about them in Chapter 3.

- **Internationalization of the bond market:** The U.S. government isn't the only government to issue bonds. U.S. corporations aren't the only corporations to issue bonds, either. For added portfolio diversification, and possibly a higher yield, you may want to look abroad. Until recently, international diversification in fixed income was very difficult. Now, it's as easy as (but not as American as) apple pie. As with U.S. bonds, you have your pick of short-term or long-term bonds, safe-and-simple or risky-with-high-return potential. You can invest in the relatively calm waters of Canada, Japan, or Germany. Or you can travel to countries such as Russia and Brazil where the bond markets are choppy and exciting. Join me on the voyage abroad in Chapter 3.