

What Types of Bonds Are Available?

Bonds are issued by federal, state, and local governments; agencies of the U.S. government; and corporations. There are three basic types of bonds: U.S. Treasury, municipal, and corporate.

Treasury Securities

Bonds, bills, and note issued by the U.S. government are generally called “Treasuries” and are the highest-quality securities available. They are issued by the U.S. Department of the Treasury through the Bureau of Public Debt. All treasury securities are liquid and traded on the secondary market. They are differentiated by their maturity dates, which range from 30 days to 30 years. One major advantage of Treasuries is that the interest earned is exempt from state and local taxes. Treasuries are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, so there is little risk of default.

Treasury bills (T-bills) are short-term securities that mature in less than one year. They are sold at a discount from their face value and thus don't pay interest prior to maturity.

Treasury note (T-note) earn a fixed rate of interest every six months and have maturities ranging from one year to 10 years. The 10-year Treasury note is one of the most quoted when discussing the performance of the U.S. government bond market and is also used as a benchmark by the mortgage market.

Treasury bonds (T-bonds) have maturities ranging from 10 to 30 years. Like T-note, they also have a coupon payment every six months.

Treasury Inflation-Protected Securities (TIPS) are inflation-indexed bonds. The principal of TIPS is adjusted by changes in the Consumer Price Index. They are typically offered in maturities ranging from five years to 20 years.

In addition to these treasury securities, certain federal agencies also issue bonds. The Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corp. (Freddie Mac) issue bonds for specific purposes, mostly

related to funding home purchases. These bonds are also backed by the full faith and credit of the U.S. government.

Municipal Bonds

Municipal bonds (“munis”) are issued by state and local governments to fund the construction of schools, highways, housing, sewer systems, and other important public projects. These bonds tend to be exempt from federal income taxes and, in some cases, from state and local taxes for investors who live in the jurisdiction where the bond is issued. Munis tend to offer competitive rates but with additional risk because local governments can go bankrupt.

Note that, in some states, investors will have to pay state income tax if they purchase shares of a municipal bond fund that invests in bonds issued by states other than the one in which they pay taxes. In addition, although some municipal bonds in the fund may not be subject to ordinary income taxes, they may be subject to federal, state, or local alternative minimum tax. If an investor sells a tax-exempt bond fund at a profit, there are capital gains taxes to consider.

There are two basic types of municipal bonds. General obligation bonds are secured by the full faith and credit of the issuer and supported by the issuer’s taxing power. Revenue bonds are repaid using revenue generated by the individual project the bond was issued to fund.

Corporate Bonds

Corporations may issue bonds to fund a large capital investment or a business expansion. Corporate bonds tend to carry a higher level of risk than government bonds, but they generally are associated with higher potential yields. The value and risk associated with corporate bonds depend in large part on the financial outlook and reputation of the company issuing the bond.

Bonds issued by companies with low credit quality are high-yield bonds, also called junk bonds. Investments in high-yield bonds offer different rewards and risks than investing in investment-grade securities, including higher volatility, greater credit risk, and the more speculative nature of the issuer. Variations on corporate bonds include convertible bonds, which can be converted into company stock under certain conditions.

Zero-Coupon Bonds

This type of bond (also called an “accrual bond”) doesn’t make coupon payments but is issued at a steep discount. The bond is redeemed for its full value at maturity. Zero-coupon bonds tend to fluctuate in price more than coupon bonds. They can be issued by the U.S. Treasury, corporations, and state and local government entities and generally have long maturity dates.

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Bonds are subject to interest-rate, inflation, and credit risks, and they have different maturities. As interest rates rise, bond prices typically fall. The return and principal value of bonds fluctuate with changes in market conditions. If not held to maturity, bonds may be worth more or less than their original cost. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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