Zero-Coupon Bonds

Zero-coupon bonds (“zeros”) represent a type of bond that does not pay interest during the life of the bond. Instead, investors buy these bonds at a steep discount from the “face value” (the amount a bond will be worth when it matures). When the bond matures, investors will receive single payments equal to their initial investments plus the accrued interest.

Available in the secondary market and issued by the U.S. Treasury, corporations, and state and local government entities, zeros typically have long maturity dates, such as 10, 15, or more years. The initial price of a zero depends on the number of years to maturity, current interest rates, and the risk involved. For example, a zero-coupon bond with a face value of $5,000, a maturity date of 20 years, and a 5% interest rate might cost only a few hundred dollars. When the bond matures, the bondholder receives the face value of the bond ($5,000 in this case), barring default.

The value of zero-coupon bonds is subject to market fluctuations. Because these bonds do not pay interest until maturity, their prices tend to be more volatile than are bonds that make regular interest payments. Interest income is subject to ordinary income tax each year, even though the investor does not receive any interest until the bonds mature.

The return and principal value of bonds fluctuate with changes in market conditions. If sold prior to maturity, a bond may be worth more or less than its original cost.

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