Fundamentals of Money Management

The Securities Market

In prior articles for this series we've discussed preparation for investing and the securities market with special emphasis on the Stock Market. In the next series of articles I will describe Bonds and the Bond Market.

The Bond (Fixed Income) Market

The Bond Market is the largest securities market in the world and exceeds $100 Trillion.

What is a Bond?

A Bond is a **Fixed-Income** Se**curity.** Actually, a bond is a specific type of fixed income security although, in general, the term "Bond" has been used as a generic description for fixed income securities. These securities are called Fixed Income because they have:

A fixed interest rate.
A fixed payment period.
A fixed period of time to maturity.

Note: Some bonds have an adjustment component built into the security and will be denoted in its Prospectus).

Bonds - Provide investors with less volatility (extreme price movements) than the stock market. Bonds have yearly returns that are less than those of stocks. The use of bonds in an investment portfolio has an important feature: **Asset Protection**!

Asset protection happens when a bond is held to maturity and maintains its stated value. This feature will add stability and income to your portfolio returns.

Salient features of having bonds in your portfolio:

Bonds are like IOUs. Buying a bond means you are lending out your money.
Bonds have fixed cash flows.
Bonds diversify your portfolio.
Issuers of bonds are governments and corporations.
Bonds are characterized by:

- The amount of its par value (called 100% of Par).
- Price of their face value.
- Coupon rate.
- Maturity and;
- Issuer.

Bonds can be purchased:

- At Par (100%) meaning if it is a $1,000.00 bond, its costs is $1,000.00.
- At a Discount (less than 100% or 98%) meaning a $1,000 bond will costs $980.00 and matures at $1,000.00.
- At a Premium (more than 100% or 102%) meaning a $1,000 bond will costs $1,200.00 and matures at $1,000.00. Note: These bonds will have a higher interest rate thus the higher premium price.

Types of Bonds (Fixed Income Securities)

Government Treasuries

There are three main categories of Government securities:

Bills - Debt securities maturing in one year or less. Sold in increments of $1,000.00 to $5 million.

Notes - Debt securities that mature in more than one to 10 years. These notes pay interest every six months.

Bonds - Debt securities that mature in more than 10 years. These bonds pay interest every six months.

Zero-Coupon Bonds

This bond is issued at a discount and makes no coupon (interest) payments. It is purchased at 98% and pays 100% at maturity.

Corporate Bonds

A corporation can issue bonds just as it can issue stock.

Short-term corporate bonds are less than five years.

Intermediate bonds are five to 12 years.

Long term bonds are over 12 years.

Asset and Mortgage Backed Securities (ABS & MBS)

An **asset-backed securit**y is secured by a collateral asset. These can be cars, credit cards, expensive portraits, coins or collectibles items that have value.

A **mortgage backed security** is a collection of properties (i.e. mortgages) packaged into a single security. All of these securities are "securitized" and are bought and sold on the open (secondary) market.

MBS payment structures are different from the coupon payments of government securities. They pay interest on a monthly basis. Known as Fannie Mae and Freddie Mac, these are quasi-government sponsored industries that control the majority of the mortgage market in the United States. Other private institutions can securitize MBS' but do not have the quasi-government backing as Fannie Mae and Freddie Mac.

Municipal Bonds

Known as "munis", these bonds are issued by local governments and are free from federal taxation. Some local governments issue tax free bonds for their residents, thus making some municipal bonds completely tax free. The interest rates on these bonds are usually lower than those of a taxable bond.

High Yield Bonds (Non-Investment Grade or Junk Bonds)

These bonds are high risk, high reward investment instruments. They are normally used in mergers and acquisitions (take overs), leveraged buyouts.

In our next article we will continue our discussion of the Bonds with emphasis on Rating Agencies and Bond Valuations.

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