Fundamentals of Money Management

The Securities Market

In prior articles for this series we have discussed preparation for investing and the securities market with special emphasis on the Stock Market. In this series I will continue Bonds and the Bond Market.

The Bond (Fixed Income) Market (Cont')

In our prior article we discussed the basic definition of what constitutes a Bond and the various types of bonds that make up the bond market. In this article our focus will be on Bond Rating Agencies and Valuations.

Credit Rating Agencies

Bonds are rated by "**Credit Rating Agencies**" who look at the credibility of the company issuing the security.

Bond Rating

Moody's	S&P/ Fitch	Investment Grade	Investment Grade
Aaa	AAA	Investment	Highest Quality
Aa	AA	Investment	High Quality
A	A	Investment	Strong
Baa	BBB	Investment	Medium Grade
Ba, B	BB, B	Junk	Speculative
Caa/Ca/C	CCC/CC/C	Junk	Highly Speculative
C	D	Junk	In Default

The Bond Rating Chart shows an at-a-glance view of the credit ratings used to give buyers an idea of the credibility and financial strength of a fixed income security. The two most widely used rating agencies are: Standard & Poors/Fitch and Moody's (there are others). These agencies rate a bond like we get grades in schools. In this chart, Standard and Poor's highest rating is AAA, while Moody's rating is Aaa. They both mean the same thing: High Quality Investment Grade Security. Once a bond falls to BBB or Baa, it is not investment grade. A bond rating lower than CCC or Caa is like a credit score: it tells the buyer this bond is a high-risk investment. It may be in default or the issuer is behind on its payments.

During the financial crisis of 2008, these agencies were criticized for not identifying the creditworthiness of many mortgage backed securities. Since bond issuers pay the agencies for their service, the trust of the rating agencies come into question. Now, we are witching them more closely.

Today you must do your own homework and not rely solely the rating agencies. Look at other aspects of the company's financial strength, the character of its management and its product/service for on-going profitability.

Bond Evaluation (Valuation)

In purchasing bonds, you need a method of evaluating it. The best way to evaluate a bond is through its **Yield**. Bond yields are used to compare different bonds that appear to be similar.

The simplest way to think of bond yield is:

> The more you pay, the less yield you get. This is called **Premium** pricing because you are paying more than 100% for the security. The interest rate and interest payment is higher than the current market interest rate, thus, the trade-off is the higher price. Example: you pay $1,200.00 for your bond, but you get $1,000.00 back. In this case your yield is 0.83% ($1,000.00/$1,200 =.833).
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> The less you pay, the more yield you get. This is called **Discount** pricing because you are paying less than 100% for the security. The interest payment is lower than the current market rate, thus, the lower price. Example: you pay $800.00 for your bond, but you get $1,000.00 back. In this case your yield is 12.5% ($1,000/$800 = 12.5%).
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> The behavior of bonds goes something like this:
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> - When the price goes up, yield goes down.
> - When the price goes down yield goes up.
> - When interest rates rise, the price of bonds in the market falls.
> - When interest rates fall, the price of bonds in the market goes up.

Government bonds are considered the safest bonds, followed by municipal bonds, and then corporate bonds.

Bonds are not risk free. It's always possible - where the borrower (corporation/municipality) can default on its debt payments.

Bonds can be bought through a brokerage firm or a bank. If you are a U.S. citizen, you can buy government bonds directly from the U.S. Treasury Direct.

The use of bonds in an investment portfolio has an important feature: **Asset Protection**!

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

In our next article we will talk about Mutual funds.

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