



Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year \$1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original

price of \$1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

Advisor Corner



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