What is a Bond?

Answer:

When you invest in bonds, you are investing in the debt of a government entity or a corporation. A bond is simply evidence of a debt and represents a long-term IOU.

Bonds are issued by federal, state, and local governments; agencies of the U.S. government; and corporations. By selling debt with a promise to pay it back with interest, the issuing agency can raise capital to finance its operations.

The issuing company or government entity will outline how much money it would like to borrow, for what length of time, and the interest it is willing to pay. Investors who buy bonds are lending their money to the issuer and thus become the issuer's creditors. Bonds are sold at "par" or "face" value, which is the price at which the bond is issued, usually in denominations of $1,000 or $5,000.

By purchasing a bond, you are lending the debtor money. In exchange, you receive a note stating the amount loaned, the interest rate (the "coupon" or "coupon rate"), how often the interest will be paid, and the term of the loan.

The principal (the amount initially paid for the bond) must be repaid on the stipulated maturity date. Before that date, you (as lender) receive regular interest, usually every six months. The interest payments on a bond are usually fixed.

Before 1983, bondholders would receive coupons that they would clip and mail in semi-annually to receive the interest payments. Presently, all bonds are issued electronically in book-entry form only.

If you are considering buying a bond, remember that the market value of a bond is at risk when interest rates fluctuate. As interest rates rise, the value of existing bonds typically falls because the interest rate on new bonds would be higher. The opposite can also happen as well. Of course, this phenomenon applies only if you decide to sell a bond before it reaches maturity. If you hold a bond to maturity, you will receive the interest payments due plus your original principal, barring default by the issuer. Additional considerations are a bond's maturity date and credit quality. Investments seeking to achieve higher yields also involve a higher degree of risk.