

Got money to lend? Buy bonds

"Hey, can I borrow some money?"

You've probably heard that question from a friend or a sibling. Now imagine you've been asked the same question, but not from your kid sister. This time the one in need of some cash just happens to be Microsoft. Or Disney. Or the federal government.

If you decide to lend them some money, you've just purchased a bond, one of the most popular investments in the U.S.

Bonds make you the lender

When a business or the government wants to raise some extra money, they issue a bond. A bond is simply an investment with a guaranteed rate of return. A bond is a lot like a loan, only instead of borrowing, you're the one lending them money.

Let's say your town decides to build a new high school. To raise funds for construction, the local government decides to borrow some money from the individuals who live in the community. The government issues bonds at \$1,000 each. If you buy one, it means you've just lent \$1,000 to help build a school.

The government promises to pay back the bond in a given amount of time. Let's say this bond lasts 10 years. It also promises to pay interest on the loan. In this example, the bond pays a rate of 5% every year.

In 10 years, the government will give you your \$1,000 back. But it also will pay you \$50.00 every 12 months—which you don't receive until maturity. At the end of 10 years, you'll have a total of \$500 in interest, plus the original \$1,000.

There's one more key feature of a bond that makes it different than a traditional

loan. People sell the bonds all the time.

If you grow tired of your \$1,000 investment, you can sell your bond to someone else. That person will now receive the \$1,000 at bond maturity, plus all of the remaining 5% annual interest payments.

A **bond** is a legal document that is a promise to repay the borrowed amount (the principal) along with interest on a certain date (the bond's maturity).

Federal, state, and local governments, corporations, and other types of institutions raise capital by selling bonds to investors.

Risky business

Government bonds are considered low-risk. That means you're certain to get back your original investment plus interest. Other investments, like stocks and mutual funds, are higher-risk. When you purchase shares of a stock, you usually aren't guaranteed to make money.

Different types of bonds carry different levels of risk. Government bonds are usually a safe investment. When a business issues bonds, the investment is considered riskier. A corporation could make bad decisions, and go out of business. If that happens, it won't be paying back its loans. To compensate you for accepting a higher risk, these bonds usually pay a higher interest rate.

Of course bonds from a large and successful business like Microsoft or Disney are still considered pretty safe. When a less stable corporation issues a bond, or when the bond money will be used to invest in a risky project, the interest rate is higher still. These high-rate, high-risk investments are often referred to as 'junk bonds.' With a name like that, you'd better be careful before lending your money!

Investing in government bonds is a way to show support for a new community project.

Pros and cons

You know what's good about a bond. Most of them are low-risk investments that provide a regular return in the form of interest payments. Investing in a government bond also shows your support for a new project--the construction of a new city park, for example.

So what could possibly be bad about investing in bonds? Consider our earlier example where you helped fund a new school. Remember, you're earning 5% per year in interest. Suppose interest rates rise one year after you bought your bond, making other investments more attractive. During that time, suppose the government issues more bonds to pay for the final stage of the school's construction.

To get new investors to buy the new 10-year \$1,000 bonds, the government might have to pay more, say, an 8% interest rate! Buyers of this new bond will receive a total of \$80 per year in interest over the next decade. Your 5% investment suddenly doesn't look so good, does it? You're stuck with that low rate, unless you can find a buyer. But who would buy your 5% bond when they can get one directly from the government paying 8%? In order to sell your bond, you'll have to lower your asking price. That would mean selling your \$1,000 bond for less.

Check the report card

While the concept of a bond is fairly simple, the world of bonds can be very complex. Between the federal government, state and local governments, and corporations, there are tens of thousands of different bonds to choose from.

How can you possibly know which bonds are risky, and which are safe investments? Different companies will actually rate bonds, and give them grades much like those found on a report card.

Look for these ratings with the bond issuer, in financial newspapers or magazines, or on the Web. Most often, a triple-A rating will signify a high quality bond, while a single-C or D will imply a junk bond.

Learn more about bonds at www.sec.gov/answers/bondfunds.htm.

Figures used are to provide an example only. You'll need to do your own research for specific bonds and current interest rates.

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