Chapter 11:2 Bonds and other Financial Assets
Objectives:

- We will describe the characteristics of bonds as financial assets.
- We will identify different types of bonds.
- We will study the characteristics of other types of financial assets.
“Cast thy bread upon the waters: for thou shalt find it after many days. Give a portion to seven, and also to eight; for thou knowest not what evil shall be upon the earth.” Ecc 11:1-2.
o Bonds are basically loans, or IOU’s that represent debt that the seller, or issuer, must repay to an investor.

o Bonds, typically pay the investor a fixed amount of interest at regular intervals for a specific amount of time.

o Bonds are generally low-risked investments.

o The rate of return on bonds is usually also lower than for many other investments.
Three Component Bonds.

1. **Coupon Rate**: The Coupon rate is the interest rate that a bond issuer will pay to a bond holder.
Three Component Bonds.

(2) Maturity: The time at which payment to a bondholder is due is called the bond’s maturity.

- The length of time to maturity varies with different bonds.
- Bonds usually mature in 10, 20, or 30 years.
Three Component Bonds.

(3) Par Value, a bond’s par value assigned to the issuer, is the amount to be paid to the bondholder at maturity.

- Par value is also called the face value or principal.
How much money will you earn from this bond and over what period of time?

The coupon rate is 5 percent of $1,000 per year.

This means that you will receive a payment of $50 (.05 x $1,000) each year for 10 years, or a total of $500 interest.

In 10 years, the bond will have reached maturity, and the company’s debt to you will have ended.

Thus for your $1,000 investment, you will have received $1,500 over a period of 10 years.
Three Component Bonds.

• Not all bonds are held to maturity.
• Over their lifetime they might be bought or sold, and their price may change.
• Because of these shifts in price, buyers, and sellers are interested in a bond’s yield, or yield to maturity.
• Yield is the annual rate of return on a bond if the bond is held to maturity.
Advantages and Disadvantages to the Issuer:

• From the point of view of the investor, bonds are good investments because they are relatively safe.
• Bonds are desirable from the issuer’s point of view as well for two main reasons.
Advantages and Disadvantages to the Issuer:

(1) Once the bond is sold, the coupon rate for that bond will not go up or down.
- The issuer will be making fixed payments for a specific length of time.

(2) Unlike stockholders, bondholders, do not own a part of the company.
- Therefore the company does not have to share profits with its bondholders if the company does particularly well.
Advantages and Disadvantages to the Issuer:

On the other hand bonds also pose two main disadvantages to the issuers:

(1) The company must make fixed interest payments, even in bad years when it does not make money.

  o In addition, it cannot change its interest payments even when interest rates have gone down.

(2) If the firm does not maintain financial health, its bonds may be downgraded to a lower bond rating and thus, maybe harder to sell unless they are offered at a discount.
Types of Bonds: Saving Bonds

- Are low denomination ($50 to $10,000) bonds issued by the United States government.
- The government uses funds from the sale of savings bonds to help pay for public works projects such as buildings, roads, and dams.
- Like other government bonds, savings bonds have virtually no risk of default or failure to repay the loan.
Savings Bonds:

- The federal government pays interest on saving bonds.
- However unlike most other bond issuers, it does not send interest payments to bondholders on a regular schedule.
- Instead, the purchaser buys a savings bond for less than par value.
- For example, you can purchase a $50 savings bond for only $25.
- When the bond matures, you receive the $25 you paid for the bond plus $25 in interest.
Treasury Bonds, Bills, and Notes:

- The United States Treasury Department issues treasury bonds as well as treasury bills and notes.
- These investments offer different lengths of maturity.
- Backed by the “full faith and credit” of the United States government, these securities are among the safest investments in terms of default risk.
Treasury Bonds:

- One possible problem with bonds and investment in general is inflation.
- The purchase price and return on the Treasury securities are governed by changing interest rates and market conditions.
- As a result, the value of treasury securities as an investment must be carefully understood.
Treasury Bonds:

- If a treasury bond pay you 5 percent interest per year but the inflation rate is 3 percent you are really getting just 2 percent interest on the bond.
- One type of bond issued mainly by the government seeks to protect against inflation is a general rise in prices.
- The inflation indexed bond links the principal and interest to an inflation index—a measure of how fast prices are rising.
- If the index rises by 3 percent, this bond’s par value will also rise by 3 percent.
- As a result, you will receive the return on the bond that you expected when you bought it.
Municipal Bonds:

- State and local governments and municipalities (government units with corporate status) issue bonds to finance such projects as highways, state buildings, libraries parks and schools.

- These bonds are called municipal bonds.
Municipal Bonds:

- Because state and local governments have power to tax, investors can assume that these governments will be able to keep up with interest payments and repay the principal at maturity.
- Interest paid on municipal bonds is not subject to income taxes at the federal level or in the issuing state.
Municipal Bonds:

- Because they are relatively safe and are tax exempt, are very attractive to investors as a long-termed investment.
- A high quality municipal bond can pay a good return for quite a long time.
Corporate Bonds:

- Corporations issue bonds to help raise money to expand their businesses.
- These corporate bonds are generally issued in $1,000 to $5,000.
- The interest on the corporate bonds is taxed as ordinary income.
Corporate Bonds:

- Unlike governments, corporations have no tax base to help guarantee their ability to repay their loans.
- Thus, these bonds have moderate levels of risk.
- Investors in corporate bonds must depend on the success of the corporation’s sales of goods and services to generate enough income to pay interest and principal.
Corporate Bonds:

- They are regulated by the SEC (Security Exchange Commission) an independent government agency that regulates financial markets and investment companies.
- It enforces laws prohibiting fraud and other dishonest investment practices.
- Each bond is issued with an indenture agreement.
- It sets forth all the features associated with the bond.
- The interest rate is specified on the indenture agreement.
Junk Bonds:

- Bonds with a fairly high risk of default but a potentially high yield.
- These non-investment grade securities became especially popular investment during the 1980s and 1990s when large number of aggressive investors made but also sometimes lost large sums of money buying and selling them.
Junk Bonds:

- Junk bonds have been known to pay more than 12 percent interest at a time when government bonds were yielding only about 8 percent.
- On the other hand the speculative nature of most junk bonds makes them very risky.
- Investors in junk bonds face a strong possibility that some of the issuing firms will default on their debt.
Other Types of Financial Assets:

- Certificate of Deposit (CDs) are one of the most common form of investment.
- CDs are available through banks which lend out the funds deposited in CDs for a fixed amount of time, such as six months or two years.
- CDs are attractive to small investors because they can deposit as little to $100.
- Investors can also choose among several terms of maturity.
- This means that if an investor foresees a further expenditure, he or she can buy a CD that matures just before the expenditure date.
Money Market Mutual Funds:

- Money Market mutual funds are special types of mutual funds.
- Financial intermediaries collect money from individual investors and then buy stocks, bonds, or other financial assets to form a mutual fund.
- In the case of money market mutual funds, intermediaries buy short-term financial assets.
- Investors receive higher interest on a money market mutual fund than they would receive from a saving account.
- They are not covered or insured by the FDIC and thus is riskier than a savings account.
- Bank deposits by FDIC is covered to $250,000.
Financial Asset Markets:

- Capital Markets: Markets in which money is lent for periods longer than a year are called capital markets.
- Financial assets that are traded in capital markets include long term CDs and corporate and government bonds that require more than a year to mature.
Financial Asset Markets:

- Money Markets: Markets in which money is lent for periods of one year or less are called money markets.
- Financial assets that are traded in money markets include short-term CDs, treasury bills, and money market mutual funds.
Financial Asset Markets:

- Primary and Secondary Markets: Markets may also be classified according to whether assets can be resold to other buyers.
- This type of classification includes secondary markets.
- Primary Markets: Financial assets that can be redeemed only by the original holder are sold on primary markets.
- Examples include saving bonds, which cannot be sold by the original buyer to another buyer.
- Small certificates of deposit are also in the primary market because investors would most likely cash them in early rather than try to sell them to someone else.
Financial Asset Markets:

- Secondary Markets: Financial Assets that can be resold are sold on secondary markets.
- This option for resale provides liquidity to investors.
- If there is a strong secondary market for an asset, the investor knows that the asset can be resold fairly quickly without a penalty, thus providing the investor with ready cash.
- The secondary market also makes possible the lively trade in stock that is the subject to the next section.
Discussion Question

If the government is selling bonds for a specific purpose, what bonds are you willing to buy?

To support the military during times of war?
To build bridges and improve roads?
To build Schools?