THE BOND THREAT

Not understanding bonds can be dangerous to your financial health. That danger looms darker than ever in times of stock market uncertainty and low interest on certificates of deposit (CD's) because seniors are searching for alternatives to these otherwise commonly used long-term financial vehicles.

What is a bond? Generally, it is a loan of money to a corporation or government institution for a specified number of years, with a promise of interest payments at a fixed rate until the principal is repaid at the end of the period. Again, when you buy a bond you are making a loan at a fixed rate.

Seniors too often when they are considering the risks of such an investment only examine the credit risk, not the interest rate risk. Let's make sure we understand both, discussing credit risk first. Credit risk springs from the possibility that the organization making the loan will not be able to repay it. To reduce credit risk, one might buy a U.S. government bond rather than a corporate bond, the assumption being that the U.S. government is ultimately more likely to repay. Or, one might choose a larger, stronger, more solvent, more diversified type of corporate bond issue over that of a smaller, weaker, less solvent, less diversified corporation.

Why would anyone ever choose higher credit risk bonds over lower? Higher credit risk bond issuers are generally forced by supply and demand in the market to pay higher interest to investors. Lower credit risk bonds generally pay lower interest. For example, consider higher risk corporate bonds, sometimes called high-yield bonds, sometimes junk bonds. These would generally pay higher interest than very high quality, very low risk corporate bonds, usually referred to as investment grade. On the other hand, based on the same principle, the investment grade corporate bond would be expected to pay more than an otherwise similar but lower risk U.S. government bond.

Many seniors, once they recognize and understand the issue of credit risk, choose bonds with less such risk. Realizing they may be sacrificing interest return with this decision, they seek other ways to increase interest. One way to potentially accomplish this goal is to increase the term of the bond, that is, the number of years before the principal will be repaid. While longer term bonds do generally pay more interest than shorter term, they also have a greater interest rate risk, which, as mentioned before, is a threat too many seniors overlook.

What is interest rate risk? It is the danger than the fixed rate on the bond owned will be less desirable in the future than now. Why is this possibility a threat? Imagine purchasing a newly issued $1000 bond today that has a coupon rate of 6%--that is, it pays $60 per year in interest. Now, suppose that economic times change and in a few months bonds of similar risk and term are now being issued at coupon rates of 8%--$80 per year. At this point in time, you own a bond that pays only $60 per year and obviously, all else being equal, you would prefer one that pays $80. How do you switch from one to the other? Well, you might sell the bond you already own in the market so you will have the cash to buy the new bond. But place yourself in the shoes of the person buying your bond, the bond earning only $60 per year--why would he pay you $1000 to earn $60 per year when he can elsewhere pay the same price for a bond that pays $80 per year. Answer: He will not. He will pay you only a discounted price.

This discounted price is determined by market demand, but that demand is affected by at least two factors. One is the interest differential, that being in this example the difference between 6% and 8%. Another is the absolute number of years before the bonds mature, keeping in mind that in our example the assumed term is the same for both. If the number of years until maturity of each bond is small, then the discount will be small, because the buyer will be earning the disadvantageous smaller interest for a shorter period of time. If the term of the bonds is much larger, for example twenty, thirty, even forty years, then the discount will be relatively large because the disadvantageous interest rate will be earned much longer.

Does all of this sound complicated? Actually, I have made a great effort to simplify the couple of issues discussed. And there are many other, more complex issues beyond these. Do terms such as "call", "call date", "premium", "yield to maturity", "current yield", "debenture", "subordinated debenture" mean anything to you? These hint at some other areas of concern, ones we cannot even begin to get into now.

In summary, bonds are not simple instruments, quite the opposite. They have risks you should understand completely before you invest, and that may be more true now than ever, given the present economic environment. Please be cautious.