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Corporate bonds

Corporate bonds are issued by corporations to help pay for expansion, equipment or operating expenses. Corporate bonds are a company's IOU for the money you're lending it by buying the bond. If a company were to file for bankruptcy, its bondholders would have priority over its stockholders when assets were liquidated. If a corporation's debt is considered investment-grade, the company can also issue medium-term notes through a process called shelf registration, which is less costly and permits greater flexibility in when notes are issued. The interest on corporate bonds is taxable at ordinary income rates by federal, state, and local governments.

Corporate bonds typically pay a fixed interest rate, and payments are usually made every six months. The corporate bond market is large and liquid with generally high trading volumes. The industrial sectors responsible for the bulk of corporate bonds are public utilities, transportation companies, industrial corporations, financial services companies, and conglomerates. Like stocks, bonds can be traded by brokers and bond dealers on the over-the-counter (OTC) market as well as the New York Stock Exchange (NYSE). The debt issues of major corporations are quoted and traded daily on the NYSE. Listed bonds are typically sold in \$1,000 denominations; for OTC bonds, the minimum is usually \$5,000.

Tip: *The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.*

Municipal bonds

State and local governments often borrow money to supplement tax revenues and to finance projects such as new highways, buildings or public works improvements. General obligation bonds are backed by the issuer's taxing power; revenue bonds are backed by revenues from the project being funded. Industrial development bonds fund facilities for private businesses that spur development in economically challenged areas. Some states issue what are called baccalaureate or college-saver bonds: zero-coupon bonds (see below) that are sold at a discount and help people save money for their children's in-state college education.

Municipal bonds, or munis, have traditionally been most attractive for investors in high tax brackets. That's because favorable tax treatment of municipal bonds can mean a higher return than bonds that pay taxable interest. Most states and local governments do not tax municipal bond interest from that state, though regulations vary from state to state. Also, interest from municipal bonds usually (but not always) is tax-exempt on your federal return. Whether it's taxable or not depends on what the municipality or state is using the bond proceeds to fund. For example, taxable munis might fund local sports facilities, investor-led housing developments, and certain municipal refinancing strategies that the federal government deems not to provide a significant benefit to the public at large. Private activity bonds (also known as nonessential function bonds or private purpose bonds) are those in which 10 percent or more of the bond's benefit goes to private activities or 5 percent of the proceeds (or \$5 million if less) are used for loans to parties other than government units. Generally, private activity bonds are taxable unless their use is specifically exempted from taxation. (For example, the American Recovery and Reinvestment Act of 2009 specifically exempts interest on private activity bonds issued in 2009 and 2010 from being included in calculations of the alternative minimum tax. Most private activity bonds are considered an item of tax preference and are therefore included when calculating AMT liability.)

Most municipal bonds and short-term notes are issued in denominations of \$5,000 or multiples of \$5,000. Bond interest typically is paid every six months; interest on notes is usually paid at maturity.

Note: *If you sell a municipal bond at a profit, you could incur capital gains taxes. The principal value of bonds may fluctuate with market conditions, and bonds redeemed prior to maturity may be worth more or less than their original cost. Some municipal bond interest could be subject to the alternative minimum tax.*

Treasury securities

The federal government borrows money in the same way corporations do. However, Treasury securities are very different from corporate bonds. Sold by the U.S. Department of the Treasury, they are backed by the full faith and credit of the U.S. government. For that reason, they're considered relatively safe, since the government can always raise taxes to pay its debt. Treasury securities, often are used as benchmarks against which to measure other types of investments. Rates are set at regularly



scheduled Treasury auctions. Treasury securities are issued in denominations that start at \$100 and may be purchased in increments of \$100 (though brokers may set higher minimum purchase requirements).

The most important Treasury securities for investors are:

Treasury bills (T-bills)

These are relatively short-term securities, which are available in maturities that range from 4 to 52 weeks. The Treasury regularly holds auctions to sell T-bills and set the current interest rate to be paid on them. Treasury bills are bought from the Treasury at a discount to the bill's face value and redeemed at the full face value. The difference between the discounted amount you pay when you buy a T-bill and the bill's face value represents the interest you receive. For example, if you pay \$97 when a \$100 T-bill is auctioned, you would effectively receive \$3 in interest when the bill matures and you are repaid the bill's full \$100 face value. The discount rate in this example is 3 percent. Money-market funds often invest in T-bills.

Treasury notes

The Treasury holds periodic auctions to sell various maturities that range from 2 to 10 years. Unlike T-bills, notes pay interest every six months until they mature. They are traded on the secondary market by investors who may or may not decide to hold them to maturity.

Treasury bonds

These are offered in 30-year maturities. They are often bought not only by individual investors but by institutional investors who have long-term financial obligations and need the relative safety that Treasuries offer.

Treasury Inflation-Protected Securities (TIPS)

TIPS have special inflation-protection features. Launched in 1997, they are designed to adjust both your initial investment (principal) and the interest paid every six months to reflect changes in the Consumer Price Index, a widely used measure of inflation. If the CPI increases, the Treasury recalculates your principal to reflect the change. The interest rate is fixed; however, because it is applied to that adjusted principal amount, it also will change with inflation. If the CPI figure falls, the principal will be adjusted accordingly; if deflation occurs, your principal could actually drop. The interest is paid every six months; when the TIPS matures, you will receive either the inflation-adjusted principal or your original investment, whichever is greater. TIPS are available in 5-, 10- or 30-year maturities; prices for new TIPS are determined at auction. As with Treasury notes and bonds, a TIPS' value in the marketplace depends on interest rates and returns on other investments, and you can lose money if you sell it before it matures.

Investors do not owe state or local taxes on Treasury securities; however, the interest is taxable as ordinary income on your federal return. Additionally, investors who own TIPS in a taxable account will be taxed at ordinary income rates for any increases to the principal amount, even though those increases aren't paid until the issue matures.

Treasury Floating-Rate Notes

The Treasury began issuing floating-rate notes (FRNs) in January 2014. As the name implies, the interest rate paid by an FRN can vary over time. An FRN's interest payments will rise as interest rates rise, and fall as interest rates fall; those changes occur weekly and are based on changes in the most recent discount rate for 13-week T-bills. However, interest payments are made quarterly.

Technical Note: *The interest rate on an FRN consists of two components. The spread, which represents the highest accepted discount margin in the auction at which the FRN is first offered, remains the same for the life of the FRN. The second component, the index rate, is tied to the highest accepted discount rate of the most recent 13-week T-bill. The spread plus the index rate equals the interest rate. That interest rate is applied to an FRN's par amount daily, so interest earned on an FRN accumulates every day.*

FRNs have two-year maturities and are issued only in electronic form. The minimum purchase is \$100, and FRNs must be purchased in multiples of \$100. FRNs are auctioned monthly by the Treasury.

Like other Treasury securities, FRNs can generally be purchased either through TreasuryDirect or through a broker. However, if you wish to sell an FRN, you must do so through a bank or broker (if your FRN is held through TreasuryDirect, you must first transfer it to a bank or broker who will handle the transaction). As with other Treasury securities, the interest paid by FRNs is



exempt from state and local taxes but is subject to federal income tax.

U.S. savings bonds

Like the above Treasury securities, savings bonds are issued by the U.S. Treasury. However, they are not traded on the open market, and are therefore not viewed in the same light as other Treasury securities. Unlike most bonds, which are coupon bonds or bearer bonds, savings bonds are registered bonds that bear the owner's name, and they must be redeemed by the registered owner or beneficiary. As the name implies, they are most frequently used as a savings vehicle; if used to finance a college education, all or part of the interest may not be taxed by the federal government (this benefit is phased out for individuals with higher incomes). They also are popular as gifts. Tax on savings bonds is deferred until maturity.

Two basic types can still be purchased directly from the Treasury at www.treasurydirect.gov:

- Series EE bonds pay either a variable interest rate (if bought between May of 1997 and April of 2005) or a fixed rate if bought after May of 2005. Interest is paid when the bond is redeemed, which can be done at any time after one year. However, if you redeem an EE bond within the first five years, you'll lose the most recent 3 months of interest; after five years, there is no penalty for redemption. Unlike other bonds, EE savings bonds continue to pay interest after they have matured, until 30 years after the issue date. So-called Patriot Bonds issued after Dec. 10, 2001 are EE bonds.
- Series I bonds, introduced in 1998, offer some protection against inflation. Earnings on an I bond are calculated by combining a fixed rate of return that is set when the bond is issued, and a semi-annual inflation rate that changes twice a year and is based on the Consumer Price Index (CPI). I bonds are sold at face value, and the interest is paid when the bond is redeemed. As with EE bonds, there is a penalty for redemption within five years of purchase. They will continue to pay interest, even after maturity, until 30 years after the issue date.

Some Series E and Series HH/H bonds may have matured but still make semiannual interest payments, depending on when they were issued. However, they can no longer be purchased. Other, older savings bonds, such as Series A, B, C, D, F, G, J, K, and so-called Freedom Shares, no longer pay interest and should be redeemed.

Agency and GSE bonds

Agencies of the U.S. government can issue their own bonds. So can organizations called government-sponsored enterprises (GSEs)--private agencies chartered by the U.S. government but not part of it. You can often recognize agency or GSE bonds because they're referred to by the nicknames for their issuers. For example, the bonds of the Government National Mortgage Association (GNMA) are called Ginnie Maes. The Federal Home Loan Mortgage Corp. (FHLMC) issues Freddie Macs, and bonds from the Federal National Mortgage Association (FNMA) are Fannie Maes. Fannie Mae and Freddie Mac were originally established by the federal government before becoming publicly owned corporations whose stocks traded on the New York Stock Exchange. However, in the wake of the 2008 financial crisis, both were placed under the authority of the Federal Housing Finance Agency; their stocks were delisted in 2010 but may still trade in the over-the-counter market.

All three package mortgages originated by banks, savings and loans and other financial institutions that lend money to homeowners to create (or in some cases, guarantee) securities, called "mortgage backed passthrough securities," that can be bought and sold on the open market by investors. Each investor receives a share of all payments made by the homeowners whose mortgages are in that pool. These can be highly sensitive to changes in interest rates, because if rates drop, homeowners may refinance or pay off their mortgages early.

Fannie Mae and Freddie Mac also issue coupon-bearing debt securities (agency debentures) to finance purchase of the mortgages that underlie an MBS. Any guarantees from either Fannie Mae or Freddie Mac are generally backed not by the U.S. government but by the trustworthiness and debt-paying ability of the issuer, which may include mortgages and mortgage-backed securities among its assets. However, as part of its conservatorship of the two entities, the U.S. government has effectively provided backing by agreeing to cover losses of up to \$650 billion for each agency, though there is no guarantee it will always do so.

Unlike Fannie Mae and Freddie Mac, Ginnie Mae is an agency of the U.S. Department of Housing and Urban Development. All Ginnie Maes are backed by the full faith and credit of the U.S. government. As a result of that greater security, they typically offer a lower yield than Fannies or Freddie's. Ginnie Mae does not issue debentures, and its mortgage-backed securities are made up of FHA-insured or VA-guaranteed mortgages.

The Student Loan Marketing Association, which issues Sallie Maes, also was established by the federal government but is now independent. Still other GSEs are not public companies. For example, the Federal Home Loan Banks and the Federal Farm Credit Banks are systems of regional banks; the Tennessee Valley Authority (TVA) is a corporation that is wholly owned by the federal



government. Because such agencies serve a public purpose, the credit markets assume the government would assist if a GSE were facing default; however, the government does not guarantee repayment, as it does with Treasury securities and Ginnie Maes.

International bonds

As in the U.S., foreign corporations and governments also raise capital by issuing bonds which may be sold in either their home countries or internationally. Yankee bonds are issued on the U.S. market by foreign companies; because they are denominated in U.S. dollars, they involve less risk from fluctuations in the value of the home government's currency. Bonds sold in an overseas market other than the issuer's own country are often known by nicknames that reflect the country where they are sold. For example, so-called samurai bonds are denominated in yen and sold in Japan by non-Japanese companies; bulldog bonds are denominated in pounds sterling and are sold in the United Kingdom by non-British companies.

In addition to the typical risks involved with bonds, such as default and interest rate risk, international bonds involve currency risk--the possibility of losing money because of changes in the value of the home currency of the issuer--unless they're denominated in U.S. dollars. Also, bonds issued by emerging countries may pay high yields because the risk of default may be much greater in countries at greater risk of economic or political turmoil; they also could mean increased liquidity risk if they are not traded frequently.

Eurobonds are medium- or long-term bonds issued by major borrowers, such as governments or other public bodies and large multinational corporations. Eurobonds are denominated in a currency other than that of the place from which it is issued. At issuance, eurobonds are offered simultaneously to investors in a number of countries. Eurobonds generally carry a fixed rate that is set at issue and paid annually or semiannually. The introduction of the euro and the birth of a single European financial market has resulted in a redenomination of the bonds issued by the governments of member states.

To schedule an appointment with Faye Sykes, click [here](#) .

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