Market Decode: How Bonds Work — and What They Can Do for You

With Matthew Diczok, Fixed Income Strategist, Merrill Lynch Wealth Management & Bank of America Private Bank

Please see important information at the end of this program. Recorded 2/28/18.
Matt Diczok: Stocks and bonds — they’re two words that are often paired together, but they’re very different. Stocks are in the news pretty much daily, especially when markets are volatile.

Bonds, on the other hand, are talked about less — and are a little more complicated... But they play a really important role for investors, especially when markets are unsettled. To compare the two, if owning a stock is like owning a little piece of a company, owning a bond is like owning a little piece of a loan.

Many types of borrowers - companies, governments, government agencies - issue bonds to fund a wide range of activities...

Everything from building roads and bridges, to investing in new plants and equipment, to buying other companies.

And the investors, called bondholders, get regular interest payments in return for lending money to these borrowers.

That’s the primary benefit of bonds: They pay you a set interest rate — also known as the “coupon rate” — at regular intervals until the end of a bond’s term, or its “maturity date.”

As long as the bond issuer doesn’t default, you’ll receive your investment — the “principal” amount — at that maturity date.

So let’s say you buy a 10-year, $1,000 dollar bond paying five percent interest:

You’ll receive fifty dollars every year for 10 years, and when the bond matures, you’ll get that $1000 back.

There are many different kinds of bonds issued, and which types you choose for your portfolio will depend on your goals, time horizon and how much risk you’re comfortable with.

For example, U.S. Treasury bonds are backed by “the full faith and credit of the U.S. government,” and therefore are considered the safest type of bonds, with no credit risk. For that reason, though, the interest rate they pay is relatively low.

[GRAPHIC]

(Alt Text: A picture of a lever comes on screen with two columns on either end to illustrate the types of bonds. On the left it has “more risk” at the top and...
“less risk” on the bottom. One the right it has “Lower return” at the top and “higher return” at the bottom. “U.S. Treasury Bonds” comes on screen and points to the “less risk” and “lower return” portions of the columns.

State and local governments also issue bonds—known as “Municipals”—as do “investment grade” companies— who issue corporate bonds.

Both types of issuers generally have strong credit ratings, and offer slightly higher yields than Treasuries for slightly higher credit risk.

In addition, municipal bonds are exempt from some taxes. “High-yield” corporate bonds and some international bonds – on the other hand – carry higher coupon rates but come with significantly more risk.

So there’s always a trade-off between the coupon a bond pays and the amount of credit risk it presents to its bondholders.

Another important factor: In general, the longer the time until a bond matures, the higher coupon rate you’ll receive. So a 30-year Treasury bond will generally pay a higher rate of interest than one with a maturity of 5 or 10 years for example.

When it comes to your investments, Bonds matter for several reasons.
First, they can provide you with a relatively predictable income stream.

[GRAPHIC]
1. Predictable Income Stream

Second, bond prices don’t vary as much as stock prices do. So bonds can potentially provide a source of stability in a portfolio.

[GRAPHIC]
2. Potential Source of Stability

Finally, bond prices may move differently than stock prices – rising in price as stock prices fall.

[GRAPHIC]
2. Prices may move differently than stocks

This means they’re an essential part of a well-diversified portfolio.

Whatever approach you take, knowing your tolerance for risk, your financial goals, and your timeframe for meeting those goals are essential in assessing how many and what type of bonds are best for you.

[GRAPHIC]
Know your:
- risk tolerance
- financial goals
- timeframe

IMPORTANT INFORMATION

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Investing involves risk including possible loss of principal. Asset allocation, rebalancing and diversification do not ensure a profit or protect against loss in declining markets. Past performance is no guarantee of future results.

Investments in high-yield bonds (sometimes referred to as “junk bonds”) offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer’s ability to make principal and interest payments.

Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal alternative minimum tax (AMT).
Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks, and other sector concentration risks.

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