

What Are The Different Types Of Bonds?

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Various entities issue bonds to borrow money. Of course, corporations issue bonds to increase their cash flow. If a corporation goes bankrupt, it may not be able to repay its outstanding loans.

The largest sector of the bond market is U.S. Treasury obligations (treasure bills, notes, and bonds). These securities are backed by the full faith of the U.S. Government, and are thus free from default risk. However, because the risk of these securities is reduced, returns are often diminished. Treasury bills (short-term securities) are zero-coupon bonds, meaning they do not produce semi-annual coupon payments. Zero-coupon bonds are usually purchased at a discount (for example, \$950) and the purchaser receives the face value (\$1,000) on the maturity date. Treasury bonds and notes (intermediate to long term) are similar to other bonds in that they pay a semi-annual interest payment. Although interest rates offered on treasury securities are usually lower than other bond, interest earned on these investments are exempt from state and local income taxes.

Treasury inflation-protection securities (TIPS) are bonds that provide investors with a rate of return that is adjusted for inflation. If an investor expects significant inflation or wants to insure that the purchasing power of a portfolio will not be reduced by inflation, TIPS would be an appropriate investment.

Municipal bonds (munis) are issued by state and local governments. There are two types of munis. General obligation bonds are backed by the taxing power of the government entity. Revenue bonds are serviced by specified revenue-producing projects such as a toll road. If the project fails to produce revenue, the municipality doesn't have to repay the loan. Consequently, revenue bonds are considered to be more risky than general obligation bonds. Both types of municipal bonds are generally exempt from federal income tax and local tax if you live in the state that issued the bond. Thus, these types of investments are frequently attractive to individuals in high federal tax brackets.

Like stocks, bonds can be purchased either individually or through a bond mutual fund. A bond fund simply invests in a portfolio of individual bonds. The bond fund manager collects the coupon

payments from the individual bonds and reinvests those funds into other bonds. When a bond in a bond fund matures, the face value of the maturing bond is most often simply reinvested into a new bond. Bond funds do not have a stated maturity date or coupon, and bond fund investors will not receive a repayment of principle until the fund is sold.

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