Investing in bonds, long considered boring, is now getting a lot more attention. Bond mutual funds attracted their highest level of investor dollars since 1986, setting a new record in July of $19.2 billion as investors panicked and took money out of stocks.

The business accounting scandals that have dominated the news are making bonds look even better. Some experts, however, wonder if new bond investors are jumping from the frying pan into the fire. Financial writer Jane Bryant Quinn cautions that bonds are safe and solid investments when properly used, but more often than not, they are improperly used. Although bonds typically have less volatility than stocks, they are not risk free, and some bonds carry considerably more risk than others. For example, in the mid-to late-1990s, long-term bond prices fluctuated by more than 30 percent in a single year.

It’s clear that bonds have a role to play for most investors, and they should play an essential part of the “don’t put all your eggs in one basket” approach to reducing risk. While many investors find it easier to buy bonds through mutual funds, investors still need to have a working knowledge of how bonds operate and the different types of bonds they can invest in. Here’s a brief overview:

**Bond Basics**

When you buy a bond, you are essentially making a loan to a government or corporate entity. You receive an IOU for the amount – the face value of the bond – and a future date at which that amount will be paid back to you, known as the maturity date. In addition, as is the case with any other loan, the issuer will pay you interest for the privilege of using your money – typically every six months.

The different kinds of bonds are defined by three characteristics:

- Who is the **issuer**, 
- What is the **quality** of the bond, and 
- What is the length of time to **maturity**.

**Issuers Include:**

- The **U.S. government**, which uses them to finance the national debt.
- **State and local governments**, which use them to finance schools, hospitals, airports and other large building projects.
- **Corporations**, which offer bonds to finance new factories, offices or equipment.

**Quality**

Quality reflects the credit-worthiness of the issuer of the bond. That is, it reflects how likely is it that you will get back the amount you loaned through your bond purchase. Local libraries often have two standard reference books that rate bond quality, Moody's and Standard & Poor’s. Most personal finance experts recommend that investors stick to higher-rated bonds, which are rated A or higher. AAA’s are the highest grade while junk bonds in default are rated the lowest.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
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<tr>
<td>AAA</td>
<td>Highest rating; strongest “credit-worthiness” compared to other issuers</td>
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<tr>
<td>AA</td>
<td>Most finance experts recommend you not buy bonds below this rating.</td>
</tr>
<tr>
<td>A</td>
<td>Bonds from here up to A are considered “investment grade.”</td>
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<tr>
<td>BAA or BBB</td>
<td>From this rating to C, bonds are considered “high yield” or “junk bonds.”</td>
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<tr>
<td>BA or BB</td>
<td>Lowest rating; weakest “credit-worthiness” compared to other issuers</td>
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<td>B CAA or CCC</td>
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Since the **U.S. government** is highly likely to honor its financial commitments, U.S. bonds (or Treasuries) are high-quality and low-risk so they have a AAA rating. That also means, however, that they pay relatively low interest. True to investing’s so-called risk-reward tradeoff, the lower the risk, the lower the reward.

**State and local municipal bonds or “Munis”** (for municipal bonds) are generally judged to be quite safe, and therefore also have relatively low dividends. In addition, they may offer tax advantages for higher income people.

**Corporate bonds** fall along a spectrum: well-established blue-chip companies are typically low-risk; less stable companies must offer investors higher interest rates, and thus a potentially higher return, in order to attract the level of cash they need for capital improvements. Such risky corporate bonds are politely known as “high-yield;” less politely, they’re known as “junk bonds.”

Of course, high-quality, low-risk bonds are the kind that let us sleep soundly at night. Their relatively low interest rates, however, carry risk of another kind: that their earnings will not keep up with inflation. Even at a low 3 percent inflation rate, $10,000 loses a quarter of its value over 25 years. Even newly retired investors should not put their entire investment into bonds, as stocks typically perform better over the long term.
Maturity

Maturity refers to the amount of time until your initial investment—called the principal—is due to be repaid.

- Short-term bonds generally mature in less than 2 years;
- Intermediate-term in 2 to 10 years; and
- Long-term bonds in more than 10 years.

Contrary to what many investors believe, a long-term bond carries the most risk. Why? Because of the strong link between the inflation rate and interest rates in the U.S. economy and the value of bonds. When interest rates rise, the value of bonds goes down. Think of it this way - you buy and lock into a 30 year bond and after you buy it interest rates rise, so you may be stuck with the lower earning bond for decades.

Selling Early

If you need to sell your bond before it matures and interest rates have gone up since you bought it, the bond's value will be reduced. That's because newly-issued bonds will offer a higher interest rate, in order to stay competitive with other investments. No one will want to buy your bond unless you agree to accept less than its face value, which is called “discounting.” Conversely, if interest rates fall in the general economy, a bond sold before maturity will sell at a “premium”—for more than its face value, because it pays a higher rate than the new prevailing interest rate. Just remember, if you hold your bond until maturity, you will get full value.

Bond Mutual Funds May Be Easier to Own

If choosing an individual bond seems too big a job—or their relatively high price may just be too big for your budget—you can consider investing in shares of a bond mutual fund. Bond mutual funds invest in a number of individual bonds so there is no exact maturity date for your shares, making them easier to sell.

Bond mutual funds pay a fluctuating dividend that reflects the combined interest returns of the portfolio. By investing in a pool of bonds, shareholders can spread their risk. In addition, bond mutual fund shares often cost considerably less than the $5,000 a single bond can cost.

Bond mutual funds are sorted out by investment objective, so they reflect the different categories of individual bonds that are available as described above, short or longer-term maturity, and U.S. government or corporate bonds.

In contrast to stocks, bonds are pretty straightforward: they keep their value if held to maturity and typically pay the investor interest twice a year. The interest payment is also called the coupon, reflecting the days when bonds actually came with coupons that an investor clipped off and took to the bank in order to be paid interest.
There are also zero-coupon bonds (zeros), which don’t make interest payments until the bond matures and then they pay the face value.

In Conclusion
So, yes, bonds have a place in investors’ portfolios. But before tossing out your stocks in the current dispiriting environment in favor of bonds, take the time to learn the basics. Investors need to understand their strengths and weaknesses in order to use them to their best advantage. Making sudden changes in how you invest without a solid knowledge base can carry long-term consequences that you may later regret.