Categories and Characteristics of Bonds

Convertible Bonds

Convertible Bonds may be exchanged under certain terms and conditions for the common or other stock of the issuer. They pay interest like a normal bond, but have the equity conversion feature.

Callable Bonds

A Callable Bond may be required to be redeemed by the issuer prior to maturity. If called, a Bond MUST be sold back to the company. The terms of the call price (for instance, at PAR (Or the price paid) will be preset at the time of purchase.

If a company, agency, or the government calls the bonds you own, it redeems your investment and pays back your principal. Issuers may call bonds if the interest rates drop and they have enough money on hand to pay back outstanding debt. By calling the bonds, they eliminate the expense of making further fixed-interest payments for the duration of the bond term, and can issue new bonds at a lower rate and save money. If your bond is called, you receive no more interest payments from the investment, forcing you to find another place to invest the money earlier than you anticipated. And if the company called your bonds due to an interest rate drop, you will find yourself reinvesting the money at a lower, less attractive interest rate.

International and Global Fixed Income

International fixed income bears some of the general characteristics as domestic fixed income, but the additional risk of currency risk. The value of the issuing country's money to the domestic dollar may make the rate of interest more difficult to predict. Also, the traditional Bond rating services do not rate international Bonds, making them more difficult to evaluate.

How Bonds Are Bought And Sold

New issues

Just like a new issue of stock, the decision to issue debt begins with the Board of Directors of the entity. Corporations and municipalities undergo a comprehensive financial analysis to determine whether a Bond might be right for the financial purpose, such as to finance ongoing business, or the building of a bridge or hospital. Market considerations will help determine the terms of the issue, although, the yield most often is not determined until the issue is sold. The process follows stock issuance closely, with underwriters and investment bankers playing a significant role along with the lawyers. Investors purchase the issue from distributors, which hold an amount of the issue in inventory.

The Secondary Bond Market

Most already-issued corporate, municipal, and U.S. Treasury bonds are traded Over-The-Counter (OTC) in the bond trading rooms of U.S. exchanges and brokerage firms around the country. Bond brokers and dealers use electronic display terminals that give them the latest price information and handle the transactions by telephone. Typically, a buyer searches for a seller currently offering the best price for a particular issue and calls to negotiate the trade. Brokerage firms who make a market in particular bonds keep inventories on hand to sell to their own clients or to brokers from other firms who are trying to fill an order. At the same time, dealers working for the firm try to amass a supply of bonds at the lowest possible prices. In contrast, U.S. Treasury bills and notes are sold competitively in a Dutch auction. That means the bids offering to accept the lowest interest (which means they offer to pay the highest prices) are accepted first, and the auction continues at incrementally higher bids until the quota is filled. The final bid becomes the auction rate, and all lower bidders have their orders filled at that rate. Individual investors, who make noncompetitive offers, also get the auction rate.

Bond Prices and Rating Systems

There are several firms, which rate bonds. The most commonly known are Moody's. Standard and Poor's, Duff and Phelps. Note that each rating service may rate the same Bond differently (see the chart provided below). However, a bond which is rated (for example) investment grade by one rating system will often be rated similarly by the others.

While most bonds have a par value of $1,000, the prices of different types of bonds are quoted in slightly different ways. Prices of corporate and municipal bonds are quoted in points and 8ths of a point, and each point is a unit of $10. You can multiply the listed price by 10 to get the actual price. For example, if a bond's price is quoted as 96 1/2, it's selling at $965 (96.5 x 10 = 965). Prices of Treasury bills and notes are quoted in units of 100 and 32nds of 100 (rather than 8ths) to permit subtler price differences. As with corporate and municipal bonds, you multiply the number by 10 to get the actual price. Let's say a T-bond's price is 100 and 9/32 (sometimes abbreviated as 100:09). To get the actual price you convert the fraction to a decimal (9/32 = 9 x 0.3125 = 2.8125). Then you attach it to the end of the whole number. So a bond quoted as 100 and 9/32 is selling for $1,002.81. A bond quoted at 100 is trading at its exact par value ($1,000). A bond quoted over 100 is trading at a premium. And, a bond quoted under 100 is trading at a discount.

Rating services consider many key issues in rating a bond, including:

- The bond issuer’s overall financial condition
- The issuer’s debt profile
- How fast the company’s revenues and profits are growing
- The state of the economy
- How well similar corporations or governments are doing given the current economic environment

The primary concern of these rating services is to alert investors to the risks of a particular issue, and to continue evaluating the financial condition of the bond’s issuer until the bond reaches maturity. Depending on the issuer’s current and ongoing financial condition, a bond’s rating may rise or fall in quality. A drop in a bond’s rating is one of the risks you face as a bond investor. If an issuer’s financial condition deteriorates, rating services may downgrade the rating of a corporate or municipal bond. In the worst case scenario, the bond goes into default. Default occurs when the bond issuer fails to pay interest as it comes due and/or fails to repay the par value of the bond at maturity.

The bond quality rating systems of the two major services are similar, but not identical. Both services also make distinctions within categories Aa/AA and lower. Moody's uses a numerical system (1,2,3,) and Standard & Poor's uses a + or –. Investment-grade generally refers to any bonds rated Baa or higher by Moody's, or BBB or higher by Standard & Poor's. Junk bonds are the lowest-rated corporate and municipal bonds — meaning there's a greater-than-average chance that the issuer will fail to repay its debt. But investors may be willing to take the risk of buying these low-rated bonds because the yields are often much higher than on other, safer investments. However, the prices are volatile as well, exposing investors to additional risk if they have to sell before maturity.

Bond Rating Systems Used by Different Rating Agencies *(Source: Ian Lohr)*

Level of Credit Risk	Moody's	S&P	Fitch	Duff & Phelps
INVESTMENT GRADE				
Highest Quality	Aaa	AAA	AAA	AAA
Very Strong	Aa	AA	AA	AA
Strong	A	A	A	A
Medium Grade	Baa	BBB	BBB	BBB
NOT INVESTMENT GRADE				
Somewhat Speculative	Ba	BB	BB	BB
Speculative	B	B	B	B
Possibility of Default	Caa	CCC	CCC	CCC
Most Speculative	Ca	CC	CC	CC
Interest Unpaid or Bankruptcy Filed	C	C	C	C
In Current Default	D	D	D	D