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Investment Basics

Everything You Need to Know About Bonds: The Many Different Kinds of Bonds

In the 1970s, the modern bond market began to evolve. Supply increased and investors learned there was money to be made by buying and selling bonds in the secondary market and realizing price gains.

Until then, however, the bond market was primarily a place for governments and large companies to borrow money. The main investors in bonds were insurance companies, pension funds and individual investors seeking a high quality investment for money that would be needed for some specific future purpose.

As investor interest in bonds grew in the 1970s and 1980s, (and faster computers made bond math easier), finance professionals created innovative ways for borrowers to tap the bond market for funding and new ways for investors to tailor their exposure to risk and return potential. The U.S. has historically offered the deepest bond market, but Europe has expanded greatly since the introduction of the euro in 1999, and developing countries undergoing strong economic growth in the 2000s have become integrated into what is now a global bond marketplace.

Broadly speaking, government bonds and corporate bonds remain the largest sectors of the bond market, but other types of bonds, including mortgage-backed securities, play crucial roles in funding certain sectors, such as housing, and meeting specific investment needs.

Government Bonds

The government bond sector is a broad category that includes "sovereign" debt, which is issued and backed by a central government. Government of Canada Bonds (GoCs), U.K. Gilts, U.S. Treasuries, German Bunds, Japanese Government Bonds (JGBs) and Brazilian Government Bonds are all examples of sovereign government bonds. The U.S., Japan and Europe have historically been the biggest issuers in the government bond market.

A number of governments also issue sovereign bonds that are linked to inflation, known as inflation-linked bonds or in the U.S., Treasury Inflation Protected Securities (TIPS). On an inflation-linked bond, the interest and/or principal is adjusted on a regular basis to reflect changes in the rate of inflation, thus providing a "real," or inflation-adjusted, return. But, unlike other bonds, inflation-linked bonds could experience greater losses when real interest rates are moving faster than nominal interest rates.

In addition to sovereign bonds, the government bond sector includes subcomponents, such as:

- Agency and "Quasi-Government" Bonds: Central governments pursue various goals – supporting affordable housing or the development of small businesses, for example – through agencies, a number of which issue bonds to support their operations. Some agency bonds are guaranteed by the central government while others are not. Supranational organizations, like the World Bank and the European Investment Bank also borrow in the bond market to finance public projects and/or development.

- Local Government Bonds: Local governments – whether provinces, states, or cities – borrow to finance a variety of projects, from bridges to schools, as well as general operations. The market for local government bonds is well established in the U.S., where these bonds are known as municipal bonds. European local government bond issuance has grown significantly in recent years. In the U.S., municipal bonds (munis) may enjoy a tax advantage over other bonds because interest on many municipal bonds is exempt from federal taxes, and when states issue bonds, interest may be tax-exempt for state residents. However, capital gains on U.S. munis are not tax exempt, and income from portfolios that invest in munis may be subject to state and local taxes and, possibly, the alternative minimum tax.

Corporate Bonds

After the government sector, corporate bonds have historically been the largest segment of the bond market. Corporations borrow money in the bond market to expand operations or fund new business ventures. The corporate sector is evolving rapidly, particularly in Europe and many developing countries.

Corporate bonds fall into two broad categories: investment-grade and speculative-grade (also known as high-yield or "junk") bonds. Speculative-grade bonds are issued by companies perceived to have lower credit quality and higher default risk than more highly rated, investment-grade companies. Within these two broad categories, corporate bonds have a wide range of ratings, reflecting the fact that the financial health of issuers can vary significantly.

Speculative-grade bonds tend to be issued by newer companies, companies in particularly competitive or volatile sectors, or companies with troubling fundamentals. While a speculative-grade credit rating indicates a higher default probability, higher coupons on these bonds aim to compensate investors for the higher risk. Ratings can be downgraded if the credit quality of the issuer deteriorates or upgraded if fundamentals improve.

Emerging Market Bonds

Sovereign and corporate bonds issued by developing countries are also known as emerging market (EM) bonds. Since the 1990s, the emerging market asset class has developed and matured to include a wide variety of government and corporate bonds, issued in major external currencies, including the U.S. dollar and the euro, and local currencies (often referred to as emerging local market bonds). Because they come from a variety of countries, which may have different growth prospects, emerging market bonds can help diversify an investment portfolio and can provide potentially attractive returns.

Mortgage-Backed and Asset-Backed Securities

Another major area of the global bond market comes from a process known as "securitization," in which the cash flows from various types of loans (mortgage payments, car payments or credit card payments, for example) are bundled together and resold to investors as bonds. Mortgage-backed securities and asset-backed securities are the largest sectors involving securitization.

- Mortgage-Backed Securities (MBS): These bonds are created from the mortgage payments of residential homeowners. Mortgage lenders, typically banks and finance companies, sell individual mortgage loans to another entity that bundles those loans into a security that pays an interest rate similar to the mortgage rate being paid by the homeowners. As with other bonds, mortgage-backed securities are sensitive to changes in prevailing interest rates and can decline in value when interest rates rise. Securities backed by fixed-rate mortgages, in particular, are sensitive to interest rates because borrowers may prepay and refinance their mortgages when rates drop, causing the securities backed by these loans to pay earlier than expected also. In part for this reason and also to appeal to different types of investors, mortgage-backed securities can be structured into bonds with specific payment dates and characteristics, known as collateralized mortgage obligations (CMOs).

- Asset-Backed Securities (ABS): These bonds are securities created from car payments, credit card payments or other loans. As with mortgage-backed securities, similar loans are bundled together and packaged as a security that is then sold to investors. Special entities are created to administer asset-backed securities, allowing credit card companies and other lenders to move loans off of their balance sheet. Asset-backed securities are usually "tranched," meaning that loans are bundled together into high quality and lower quality classes of securities. Asset-backed securities contain risks, including credit risk.

- Pfandbriefe and Covered Bonds: German securities secured by mortgages are known as Pfandbriefe or, depending on the size of the offering, "Jumbo" Pfandbriefe. The Jumbo Pfandbrief market has historically been one of the largest sectors of the European bond market. The key difference between Pfandbriefe and mortgage-backed or asset-backed securities is that banks that make loans and package them into Pfandbriefe keep those loans on their books. Because of this feature, Pfandbriefe are sometimes classified as corporate bonds. Other countries in Europe are increasingly issuing Pfandbrief-like securities known as covered bonds.

The non-government bonds described above tend to be priced relative to government bond yields or the London Interbank Offered Rate (LIBOR). The difference between the yield on a non-government bond and the government bond yield or LIBOR rate is known as the "credit spread." For example, a company with a slightly lower credit rating than its government might issue a bond with a yield or credit spread of 50 basis points (0.5%) over a government bond with the same maturity. Credit spreads adjust based on investor perceptions of credit quality and economic growth, as well as investor demand for risk and higher returns.

After an issuer sells a bond, it can be bought and sold in the secondary market, where prices can fluctuate depending on changes in economic outlook, the credit quality of the bond or issuer, and supply and demand, among other factors. Broker-dealers are the main buyers and sellers in the secondary market for bonds, and retail investors typically purchase bonds through them, either directly as a client or indirectly through mutual funds and exchange-traded funds.

A word about risk: Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

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