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Some time ago, I introduced a piece in one of our newsletters called *"Questions You Were Afraid to Ask."* The piece answered a common question many investors have but feel uncomfortable asking.

When I was young, I was taught that "The only bad question is the one left unasked." As a financial advisor, I've found that statement to be true! Every day, my clients ask me questions about the markets, taxes, their personal finances, you name it. Over the course of my career, I have never thought, "That's a stupid question." Not once. That's because stupid questions simply don't exist!

Lately, I have been discussing bonds a lot with our clients due to interest rates rising to levels we haven't seen in over 15 years. In these discussions, I've found that many investors remain somewhat baffled by bond investments, especially the "bond lingo" thrown around by folks in the financial industry. Personally, I find some of the "bond lingo" ridiculous and believe it is used to create confusion, rather than educate investors. Since I prefer to help investors by keeping things simple and understandable, I want to tackle:

Questions You Were Afraid to Ask:
What's the difference between all these types of bonds?

When you buy a bond, you are lending money to the issuer – generally a company or government. In return, the issuer promises to pay you a **specified rate of interest** on a regular basis, and then **repay the principal** when the bond **matures** after a set period of time.

As you know, the Federal Reserve has raised interest rates the past few years to the highest level since 2007. When interest rates go up, many investors start showing renewed interest in bonds, because they tend to be less volatile than stocks. But there are several types of bonds to choose from, each with different characteristics. All those options can be confusing, so I figured now would be a good time to give people a brief overview of the main types that investors have to choose from. Let's start with:

Corporate Bonds

Corporate bonds are issued by both public and private corporations. Companies use the proceeds of these bonds to buy new equipment, invest in new research, and expand into new markets, among other reasons. These bonds are usually evaluated by credit rating agencies based on the risk of the company defaulting on its debt.

Corporate bonds can be broken down into two sub-categories: **Investment-grade** and **High-Yield.** Investment-grade bonds come with a higher credit rating, implying less risk for the lender. They're also considered more likely to make interest payments on time than non-investment grade bonds.

High-yield bonds have a lower credit rating, implying higher risk for the investor. These are typically issued by companies that already have more debt to repay than the average business or are contending with financial issues. Newer companies may also issue high-yield bonds, because they simply don't have the track record yet to garner a high credit rating.

In return for this added risk, high-yield bonds typically pay higher interest rates than investment-grade bonds. In short, investment-grade implies lower risk for a lower return; high-yield implies higher risk for a higher return.

Muni-Bonds

Municipal bonds, or "munis", are issued by states, cities, counties, and other government entities so that entity can raise funds. Sometimes these funds are to pay for daily operations like maintaining roads, sewers, and other public services. Sometimes the funds are to finance a new project, like the building of a new school or highway.

Muni-bonds can also be broken down into two sub-categories: **Revenue** bonds and **general-obligation** bonds. The former are backed by the revenues from a specific project, such as highway tolls. The latter are not secured by any asset, but are instead backed by the "full faith and credit" of the issuer, which has the power to tax residents in order to pay bondholders, should that ever be necessary.

In other respects, muni-bonds work similarly to corporate bonds in that the holder receives regular interest payments and the return of their original investment. But they do come with one additional advantage, in that the interest on muni-bonds is exempt from federal income tax. (It may also be exempt from state and/or local taxes if the holder resides in the community where the bond is issued.) However, muni-bonds often pay lower interest rates than corporate bonds do.

U.S. Treasuries

Treasury bonds are the type of bonds you usually hear about in the news. As the name suggests, these are issued by the U.S. Department of Treasury on behalf of the federal government. They carry the **full faith and credit** of the government, which has historically made them a very stable and popular investment. In fact, U.S. treasuries tend to be so stable that economists often use them as a bellwether for the overall health of the entire economy.

There are several types of U.S. Treasury bonds. Treasury **Bills** are short-term bonds that mature in a few days to 52 weeks. Treasury **Notes** are longer-term securities that mature in terms of 2, 3, 5, 7, or 10 years. Finally, actual U.S. Treasury **Bonds** typically mature every 20 or 30 years. Both Notes and Bonds pay interest every six months.

Finally, we have **Treasury-Inflation-Protected Securities**, or TIPS. These are notes and bonds whose principal is adjusted based on changes in the **Consumer Price Index**, which tracks inflation. Interest payments are made every six months and are calculated based on the inflation-adjusted principal. That means if inflation goes up, so too does the principal in the bond...thereby increasing the amount of interest that is paid. However, if inflation goes *down,* the principal does too, thereby decreasing the interest rate.

Bonds are an important subject that all investors should know about, so I hope this overview was helpful! In my next letter, I'll break down some of the *terms* you will often see associated with bonds that many investors find confusing. In the meantime, have a great month!

Sincerely,

Robert G. Elliott

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