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What is a Bond? A 101 Overview

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At its core, a bond is a loan. Think of it this way: If you lend someone $100, you expect to get that money back—with interest. When you invest in a bond, you're lending money to an organization such as a government or corporation. The amount you're lending is called the par value (typically $1,000 per bond), the date you get your money back is the maturity date, and the interest you receive along the way is called the coupon payment. This is why bonds are often referred to as fixed income: you're receiving a fixed stream of payments for the duration of the loan.

WHAT TYPE OF BONDS ARE THERE?

There are many types of bonds. Some are issued by the U.S. government, others by municipalities, corporations, or even foreign entities. These bonds can range in maturity from just one month to 50 years. The longer the maturity, the more sensitive the bond tends to be to changes in interest rates. Shorter-term bonds tend to be less sensitive to these shifts, while longer-term bonds are more affected by economic uncertainty.

BOND PRICES DON'T ALWAYS STAY THE SAME

When you purchase a bond, you're locking in a fixed interest rate (coupon). But if you decide to sell that bond before it matures, its price will fluctuate based on current market conditions–particularly interest rates. This is because your bond becomes more or less attractive to other investors depending on how its coupon compares to newly issued bonds.

For example, let's say you buy a $1,000 bond that pays 2.5% interest. If interest rates later rise to 4%, someone could buy a brand-new bond and earn more. As a result, your bond would likely sell for less than $1,000–perhaps $950–because it's now offering a below-market rate. On the flip side, if rates fall to 2%, your 2.5% bond becomes more attractive, and its market value might rise to $1,100 or more.

It's important to understand that while the bond's coupon is fixed, its yield–or actual return–changes based on what you paid for it. If you pay less than face value, your yield is higher; if you pay more, it's lower. This is why bond prices move opposite interest rates. This relationship is one of the most fundamental aspects of bond investing.

SO WHY DO INTEREST RATES CHANGE?

Bond prices are influenced by the broader economy. Factors like inflation, employment, and Federal Reserve policy all play a role. For instance, if inflation rises, the Fed may raise interest rates to cool the economy. In turn, bond prices typically fall. The amount of time left until a bond matures also affects how much its price might change in response to interest rates. A one-month U.S. Treasury bill is unlikely to fluctuate much because it's so short-term. In contrast, a 30-year corporate bond will change in value more frequently due to long-term economic uncertainty and changing credit risk—the likelihood the issuer might default on payments.

HOW ARE BONDS PRICED?

Beyond interest rates, another major factor in bond pricing is credit risk—the possibility that the bond issuer may not repay you. U.S. Treasury bonds are considered virtually risk-free, which is why they offer lower yields. In contrast, corporate bonds may offer higher yields to compensate for the additional risk that the company could default. This difference in yield between two issuers—say, a Treasury and a corporation—is known as the credit spread, which reflects the perceived risk of the borrower.

In most environments, bonds that mature later offer higher yields than those that mature sooner. That's because investors usually expect to be paid more for tying up their money over a longer time. But this isn't always the case: During periods of uncertainty, the yield curve can invert, meaning short-term bonds may yield more than long-term ones. While more advanced, this concept helps investors read signals about future economic expectations.

WHEN DO YOU GET PAID?

Typically, bonds will pay you interest twice a year. At maturity, you receive the face value of the bond, usually $1,000. Unless the issuer defaults or pays off the bond early—a scenario known as call risk—you can generally count on those scheduled payments. This predictability is a key reason why bonds are used for generating reliable income.

WHO BUYS BONDS AND WHY OWN THEM?

Individuals, companies, pension funds, mutual funds, foreign governments, and hedge funds all actively participate in the bond market. These investors rely on bonds for income, stability, and capital preservation. The scale and diversity of the bond market make it one of the most important parts of the global financial system.

Over time, bonds provide income, stability, and diversification. Stocks may offer more growth, but they also come with greater ups and downs. Bonds can help cushion your portfolio during market volatility and create a more balanced investment strategy.

Let's say you're nearing retirement and want to rely less on stock market swings. Bonds can offer predictable income and help preserve your wealth. They're not just for conservative investors—they're a core building block of many long-term plans.

FINAL THOUGHTS: BONDS BELONG IN EVERY CONVERSATION

Whether you're a first-time investor or managing a complex portfolio, bonds offer tools for stability, income, and long-term planning. They can be tailored to your timeline, risk tolerance, and financial goals.

Understanding how bonds work—their pricing, risk factors, and role in a diversified portfolio—can help you make smarter, more confident decisions. If you're unsure how bonds fit into your strategy, talk to your Grimes financial advisor. It may be the right time to take a closer look at the fixed income side of your plan.

This article is part of an ongoing series aimed to help build overall financial literacy. While not a comprehensive deep dive into every single topic, it is designed to provide a helpful overview to key topics within the world of investing and financial planning. Please reach out to connect *with an advisor or expert on the subject to learn more and start planning for your financial future.*