Inside Bond Funds

We are living in uncertain times. Stocks have been getting whipsawed. Our national deficit has mushroomed. We're at war. And corporate accounting scandals have made retirement savings plan investors shy away from stock mutual funds. It's no wonder that more and more investors have turned to bonds in recent years. But be aware: Bonds have risks, too.

What is a bond?
By definition, a bond is a loan that investors make to corporations or governments over a set period of time (called the bond's "term"). A bond has a set rate at which interest is paid. When the bond matures at the end of its term, the original investment amount (or principal) is repaid to the lender.

What is a bond fund?
A bond fund is a professionally managed portfolio of bonds. Shareholders own a piece of dozens, if not hundreds, of bonds. Since bond funds continually buy and sell bonds that mature at different values and points in time, they offer no fixed maturity or repayment.

Bond funds can be risky
A common misconception among investors is that bond funds are practically risk-free. Not true. Like any investment, bond funds are subject to a number of risks, such as:

1. **Interest rate risk** is the chance that a change in interest rates will have an adverse effect on the value of the bonds in your fund. When interest rates rise, the value of existing bonds falls. This makes sense: A bond yielding 4 percent is less attractive to investors when newer bonds are paying out 5 percent, for example. Declining interest rates drive up existing bond value because older bonds are likely to pay a rate that's higher than what the market presently offers. As interest rates fluctuate, so do the values of bond funds, because they are made up of individual bonds.

2. **Credit risk** is the chance that the issuers of the bonds owned by a fund may not repay their debts to the individual investors holding the bonds.

3. **Prepayment risk**, also known as "call risk," is the possibility that the bond issuer will decide to pay back the money earlier than the maturity date. This is troubling if it occurs at a time when interest rates have declined. Funds holding these bonds may have to reinvest in bonds with lower interest rates, potentially reducing the fund's return.

What kinds of bond funds are out there?
Government bond funds are made up of bonds issued by the U.S. Treasury and its agencies to keep operations running, pay off interest on national debt, or to pay for a wide range of other government activities. Government bonds are backed by the full faith and credit of the U.S. government, and offer a high degree of safety (and low interest).

Corporate bond funds are made up of bonds issued by companies to cover operating expenses, finance expansion, modernization, corporate takeovers, or to pay for other activities. All corporate bond funds are not the same. Corporate bonds are rated according to credit quality—the reliability of the borrower to make timely payments of interest and principal. They are riskier than government bond funds because they aren't backed by the government — but they may offer higher interest rates.

Municipal bond funds ("munis") hold bonds issued by states, cities, counties and towns. They are generally free from federal, and sometimes state, income taxes. However, income may be subject to the

Alternative Minimum Tax, and capital appreciation from discounted bonds may be subject to state or local taxes. Capital gains are not exempt from federal income tax

A word to the wise...

Bonds may be hot now, but if history is any indication, they are likely to fall out of favor at some point —

and stocks will likely regain popularity. The trick for the long-term investor is to resist the temptation to put all your money into the investment-of-the-day. Think about this: If you put all your money into bond funds now, would you be making the same kind of mistake many investors made in the late 1990s when they put all their money into stock funds?

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