Why buy bonds essay

Finance

Buying bonds: Introduction: Bonds are debt securities whereby the issuer of the bonds which in most economies is the government has an obligation to repay the amount plus interest. Therefore bonds can be termed as loans which are in form of securities whereby the principle amount is paid plus the interest rate. Bonds can therefore be defined as a debt certificate issued the government or even a corporation with guaranteed payment principal amount investment plus interest on a future date. Bonds will involve the giving of a loan to a government and corporation and the holder of the bond gets paid for lending the money.

The advantage of bonds over other securities such as stocks is that they have a defined maturity when the bond is redeemed. For this reason therefore there are many added advantage when one invests in bonds. However there exist many types of bonds that available to the market including government bonds and corporate bonds.

Type of bonds: There exist many types of bonds depending on the issuer of the bonds, bonds can be issued by the government or other agencies, these type of bonds include: War bonds: These are bonds offered by the government in case of war, when there is war then the government issues bonds in order to finance these wars, this are referred to as war bonds. Zero coupon bonds: These types of bonds do not earn any interest, the holders of the bond aquire the bond as a form of savings and the only amount paid is the principle amount. The fixed rate bonds: This type of bond has a coupon that is fixed throughout the period it is held, this type of bond has minimum risk of fluctuations and therefore it is one of the best bonds to invest in.

The floating rate bond: This type of bond is based on a market index and in most cases it depends on the money index, in this type of bond the rates are adjusted frequently and therefore the terms of returns are likely to change over time. Asset backed bonds: These types of bonds are usually backed by the cash flow from asets, example bonds backed by mortgages. Perpetual bonds: Perpetual bonds are those bonds with no maturity period, these type of bonds can last even for a hundred years but their rate of return and principal values are usually very low than any other bond. Bearer bonds: These types of bonds are different from the others in that they do not contain a holder’s name, for this reason therefore any person holding the bond can claim the value. This type of bond is easily transferable from one person to another than any other bond. Registered bond: Registered bonds are the opposite of the bearer bond; this is because it contains the name of the holder and when the bond matures the earnings are sent to the holderFrom the above discussion we have derived the various types of bonds and their characteristics and therefore an individual will be in a position to choose the best option preferred, however some bonds do not exit in other economies while there may be other bonds available in other countries but the most importantly. Investing in bonds: Investment decisions are made considering the rate of return and the risk involved, the maturity period is also an important factor when considering investment.

In most cases the bonds are said to be safer investment options than the stocks. Bonds are Safer: investing in bonds is much more safer than investing in stocks, this is derived from the issue where if for example we consider the corporate bonds and the institution or company gets bankrupt then the bond holders will first be paid their dues followed by the stake holders in that order, share holders are likely to loose all their investment in this case but the bond holders are paid their dues. Some bonds that are available in the market are termed as risk free especially if the government is stable, however there are other types of bonds referred to as junk bonds that are very risky and are not safe to invest in, therefore we can conclude that investing in bonds is much more safer than investing in the stock market. Bonds are predictable: From the past experience stocks in the short run have out performed bonds, however tin the long run bonds are much better than stocks, bond earnings in most cases are smooth while stocks are likely to depreciate given a specific period, stocks will loose and gain given a specific period while bonds are steady and therefore returns are predictable.

In a case where a person invest in bonds the maturity date amount is well known to the holder of the bonds and for this reason they out perform stock whereby the stock investor may end up in a situation where ht stocks loose value. Savings and bonds: Many investors will keep their funds in savings accounts in banks where the interest rates are much lower than the interest paid by the bonds, therefore in the case where a potential investor will keep his funds in the bank and does not need it in the short run it would be better to invest the money in bonds which will earn more interest and at the same time because bonds are less risky the investor is more likely to earn in the process. Liquidity of bonds: Bonds are highly liquid, for this reason holders of bonds can easily sell his bonds to other investors with ease, the sale of bonds does not involve the risk of losing funds beocuse they have specified returns in the future. Legal protection: Not every corporation can sell bonds and this is restricted by the legal measures that are followed in many economies, the holders of the bonds can therefore feel safe to hold the bonds due to the legal protection whereby in case the company goes bankrupt the bond holders must be paid their dues due to the legal protection that follow the issuing of bonds. Monthly income: Bonds earnings may be distributed for the period in which they are possessed, equal payments are made each month depending on the type of bond and in most cases the corporate bonds provide this option. In this case therefore the bond holder has a monthly income placing bonds in a much preferred position than any other investment options. Minimum investment: The minimum investment in bonds is usually very low and for this reason anyone can invest in bonds, the minimum investment level is defined and in most cases it is usually affordable to anyone in a country including students and for this reason it helps them to invest in bonds due to the low capital commitment required. This is in contrast with the stocks market whereby companies place high minimum investment which discourages potential investors who are low income earners and therefore restricting investment due to the high capital commitment.

Potential earning: Bonds prices are likely to change in cases where the interest rates change, when interest rates fall then the prices of bonds rises, when interest rates increase then the price of bonds fall. Also in cases where the maturity period of bonds is longer then the high the possibility that ht interest rates will change, therefore when the interest rates change then there is a high possibility of increase in earning from bonds. Therefore there is a potential to increase earnings from bonds and also when bonds are purchased there is a high certainty that the stated earnings will be paid when the bond matures. Economic growth: Bonds as a source of funds for the government and corporations it helps in increased growth in an economy, this will benefit the citizens of the economy and not necessarily the individuals, war bonds are issued to investors for the purpose of financing a war. For this reason therefore the bonds will provide the government with funds that will help them undertake development projects that will help in economic growth of a country and therefore people should buy bonds.

Disadvantages of buying bonds: Despite the many advantages of bonds there are those disadvantages that are associated with buying of bonds; bonds reduce the ability to earn even more profits and also the issue of interest rates on bonds. These disadvantages are discussed below: Reduced profit potential: Bonds may in some cases reduce the chances of even earning higher profits, because the earnings of the bonds are more certain and determined on the purchase day then there is a les possibility to increase earnings of these bonds, in the stock market proper prediction of future prices of stock may lead to more earnings to an investor and therefore bonds may be seen unfavourable due to the low profit potential they posses. Interest rates changes: Bonds are likely to fluctuates as a result of changes in interest rates, stock prices are in most cases not affected by changes in the level of interest rates, this risk occurs when the interest rates change and the holder of bonds wants to sell bonds before the maturity date, for this reason the investor may experience a loss or even difficult to cash out bonds in such a case.

In the case where interest rates go up then the principle amount is returned, when this happens the bonds are called and redeemed and if an investor prefers to sell his bonds before the maturity date when interest rates are rising then there is a high possibility of making a loss because the bond will be discounted using the prevailing market rates. When interest rates are decreasing a bond investor is said to be gaining. Paying off of bonds before maturity date: A company that issues bonds may pay off its bond holders before the maturity date meaning that before the bond matures a company may cal off the bonds and pay principal amount plus the interest incurred, for this reason an investor will be forced to invest in other forms of investment example stock and this increases the chances of failing to find a good deal, a company will pay off its bonds when interest rates are falling and therefore the investor may not find a favourable investment option increasing the probability of loss due to the second investment.

Conclusion: There are various type of bonds which investors can invest in, the existence of these variety enables the investor to choose the best option to invest in, they include war bonds that are issued in order to finance war, zero coupon bonds that do not earn interest and the holders of the bond acquire the bond as a form of savings and the only amount paid is the principle amount. The fixed rate bond is another form of bond whereby the bond has a fixed rate throughout the period it is held and therefore has minimum risk of fluctuations. The floating rate bond is a type of bond that is based on a market index and depends on the money index, bond rates are adjusted frequently and therefore the terms of returns are likely to change over time.

Asset backed bonds are usually backed by the cash flow from assets. Perpetual bonds on the other hand are those bonds with no maturity period, Bearer bonds do not contain a holder's name, for this reason therefore any person holding the bond can claim the value. The Registered bond is the opposite of the bearer bond; this is because it contains the name of the holder and when the bond matures the earnings are sent to the holderFrom the above discussion we have derived the various types of bonds and their characteristics and therefore an individual will be in a position to choose the best option preferred, howeverFrom the above discussion it is clear that it is better to invest in bonds than investing in other portfolios available in the market, bonds are safer than stock in that the bonds are issued with an agreement of payment of the principal amount plus interest rate after the maturity period provided, they are also safe in that they are protected by law in most countries and bond issuers are restricted by this law, in the case where the company goes bankrupt the bond holders are the first priority in terms of paying them off their dues then the stock holders come second. The predictability of bonds is also an added advantage why people should invest in bonds, the bond earnings are predictable and they are less likely to fluctuate compared to stock, stocks are exposed to fluctuations where stock prices will rise and fall sharply over a given period. The other advantage is that the bonds can be sold by a holder and therefore they are characterised by high liquidity and therefore the ease of transferability. Other bonds especially corporate bonds will in most cases provide monthly payments to holders of the earnings and therefore provide a monthly income to bond holders, aldso the bonds will have a low minimum investment requirement whereby the minimum amount will be affordable to any one in a country, unlike the stocks where the minimum amount is usually high restricting low income earners from investing. it is clear that the bonds have a potential earning ability where the bond owner will earn at the end or even before the bond maturity period, when the interest rates decrease there is a possibility of a rise in earning from the bonds and due to their low risk nature the bonds have a high potential to earn even more.

There however exist disadvantages to why we should not invest in bonds, despite the many advantages there exist drawbacks investing in bonds but these draw backs do not out weigh the advantages of bonds, these advantages include the reduced potential earning whereby a bond holder may not have a high potential to earn more than in the stock market, investing in stock involves higher risk but in the same case involves high profit potential where good prediction on changes in prices of stock may lead to higher earnings than in the bond market. Finally the bonds are likely to be redeemed before the maturity period posing a risk, when bonds are paid off the investor may not find a favourable investment option increasing the probability of loss due to the second investment. For this reason therefore the bond investment may not be favourable. References: Dale Jorgenson (2001) Capital Investment, MIT Press, New York Donald Eugene (1992) The Investment Decision Under Uncertainty, Prentice Hall publishers, New YorkGlenn Yago (1991) Junk Bonds: How High Yield Securities Restructured Corporate America, Oxford University Press, OxfordJohn Meyer and Edwin Kuh (1997) the Investment Decision: An Empirical Study, Harvard University Press, HarvardKeith Belding (1997) United States Bonds and Securities: What They Are and Their Cost, McGraw Hill publishers, New YorkNarasimhan

Jegadeesh and Bruce Tuckman (2000) Advanced Fixed Income Valuation Tools, McGraw Hill publishers, New YorkPhilip Wood (1995) International Loans, Bonds and Securities Regulation, McGraw Hill publishers, New YorkRobert Shiller (1999) Market volatility, Prentice Hall publishers, New YorkStandard and Poor’s corporation (1979) Ratings Guide of Corporate Bonds, McGraw Hill Press,