Finance and investment essay

Economics, Currency

IntroductionInvestment in a bond is primarily dependent on three factors. Firstly, the category of bond, secondly interest and yield on bond and thirdly maturity period. Bonds are the safe investments as compared to stocks or mutual funds as U. S Treasury bonds and Government bonds are risk-free, tax-free and offer high yield and interest to buyers of bonds. The benefit of bonds investment can be derived by employees, retirees and pensioners who are facilitated with regular interest income apart from saving principal amount as bond.

Government bonds are safe as compared to corporate bonds with the fact that there is a scope for manipulation of interest rates which may lower the price of bond in trading whereas local Government [municipal bonds] and Treasury bonds are non-tradable securities as the funds are used in national programs . and roads, schools and in public work projects. One important analysis that is required before selecting the category of a bond is, risk analysis whether lower or higher that is relevant to the bond must be calculated by the investor. Risk in bonds investment invites three major risks.(1)   Period of bond until it matures : Scope for interest rate fluctuations with long period.(2)   Credit risk : Issuer may default payments to lenders.

(3)   Inflation risk: Inflation may bring down the interest rates of bonds. Further calculation of yield and interest must also be understood by investor. For example. A bond of $1000 that returns $90 as interest has a yield of 9% ($90/$1000) which is paid to investor on regular basis and the principal amount is paid only on the date of maturity. The maturity date of a bond can last until a period of even 30 years. Zero-coupon bonds can also be issued by purchase of discount bonds.

E. g. A bond can be purchased at a discount of $400 and can be redeemed for $1000 on maturity date. The following is the table of category of bonds with ratings of risks. SnoCategoryRiskYield1U.

S. Treasury bondslowest risk bonds. high yield2Mortgage bondslower risk and government guaranteedhigh yield3Municipalhigher risktax-free4Corporatehigher riskhigh yield5Internationalrisk of foreign currency fluctuationshigh yield6High yieldrisk of defaulthigh yieldBonds can be further named as high-quality and low-quality bonds basing on the financial health and solvency of a corporation or government. For example, local government bonds are considered as low-quality bonds whereas named as " higher-yield" bonds with the higher risk connected to such issue of bonds.

Bonds can be traded freely until it reaches the date of maturity. When interest rates fall, bond prices go up and vice versa. For e.

g. A bond is purchased with $5000 with interest 4%. Two years later, similar category of bond is costing $5000 with 6% interest. No buyer would be interested in buying a bond that is offering 4%, in such instance, it has to be sold less than the interest rate. Buyers generally will pay more if interest rate is high.

Also short-term and long-term bonds investment also work to the benefit of investor. Stable bonds are considered to be those that are offered with shorter maturity as there is scope of less speculation whereas the longer the term of bond, the more is scope for fluctuation of interest rates and more risk of lessening the value of bond. For this purpose, in order to maintain

the awareness among public, about bonds investment, credit ratings agencies such as S&P and Moody's thoroughly scrutinize the issue of bonds by respective authorized bodies and provide ratings for each issue. S&P investment grades are AAA, AA, A, BBB and speculative grades are BB, B, CCC, C whereas Moody's investment grades are Aaa, Aa, A, Baa and speculative grades are Ba, B, Caa, Ca, D. In bond investment a major significance exists between interest rates that may increase or lessen the value of bonds.

Market fluctuations of interest rates cause a great impact on bond market with the slogan " As interest rates rise, bond prices will fall. As interest rates fall, bond prices rise". ConclusionFrom the point of view of investor, category of bond, interest rate, yield and maturity apart from risk analysis are equally important in making an investment in bond market. Investors must consider the guidance and ratings provided by rating agencies before investing in bond market to avoid any loss of liquidity.

A thorough understanding of investment and advice of experts must be considered by investors. From the point of view of issuers, regular payment of interest, low-risk factors, higher rate of interests, tax exemptions will invite more investment into corporate bonds, governments or in Treasury bonds. Funds have to be raised from public while protecting the interests of public especially the bond market that has more provisions for safety and security of funds as compared to equity and mutual fund market, investors have to be encouraged with attractive offers in bond market to raise more public funds by government and corporate sector. References(1) Bonds,

Risk vs returnAccessed 7 June 2007http://www. aigvalic. com/fpc2003/uofa. nsf/contents/invttype_bond-rvr(2) Understanding the basics of bond investingAccessed 7 June 2007http://www. americancentury. com/workshop/articles/what_bond. jsp