TD Mutual Funds
Successful Investing. Worldwide.

ABCs of Bonds

Fixed-income investments are one of the cornerstones of a well-diversified investment portfolio. Stock market volatility over the past couple of years has seen an increased interest in fixed income, particularly bond investments. The following is an introduction to bonds and focuses on the Canadian bond market.

The ABCs of Bonds

Bonds are really nothing more than formal IOUs from the issuer, either governments or corporations. In exchange for the use of your money, the issuer promises to return the face value of your investment by a certain due date and pay you regular interest, usually semi-annually.

Many bonds are issued and mature at face value, but are bought and sold at current market value. The amount of interest you receive is the interest ("coupon") rate times the face value of your bond. For example, a $10,000 face-value bond with a coupon rate of 7% pays $700 a year in interest.

Between the time the bond is issued and the maturity date, the market price of the investment can fluctuate. Price changes only matter if you decide to sell your investment before it matures. Since market prices can change, you could realize a capital gain or loss if you sell your investment before maturity.

Investing in bonds carries more risk than money market investments since your money is on loan for a longer period. However, they will also normally offer higher returns.

Why Do Bond Prices Change?

Current Interest Rates

The value of a bond will rise and fall in the opposite direction of current interest rates. For example, a bond purchased a year ago paying 7% interest is less attractive to investors if current interest rates are 9%. To attract buyers, the bond will have to fall in price. However, if current interest rates fall to 4%, your bond paying 7% is that much more valuable. If you sell it before maturity, you will receive more than you paid. Remember, though, if you hold your bond to maturity, you will usually receive the face value (all bonds are subject to some risk – credit risk is discussed below).

Term to Maturity

Bond prices don't move up and down in lock step with interest rates. Price is also linked to the maturity date. For a given movement in interest rates, prices of longer-term investments will tend to fluctuate more than prices of shorter-term investments. However, to compensate investors, longer-term investments will normally offer higher returns.

Credit Quality

Prices are also influenced by the financial strength and stability of the issuer. Will the issuer be able to pay interest on schedule and return the principal as promised? Or is there a chance of default? Investments issued by the federal government have virtually no credit risk, since the Canadian treasury is unlikely to default on a loan. For corporations, however, insolvency is not inconceivable, and for that reason corporate bonds generally offer higher yields than government bonds.

What Kinds of Bonds Can I Buy?

Government Bonds

The Government of Canada, selected crown corporations and provincial governments in Canada raise money to fund government projects and programs by issuing bonds. Most government bonds are fully guaranteed by the issuer and generally require a minimum of $5,000 to invest. Bonds are typically issued for periods between 1 to 30 years.

Stripped Bonds

Also known as 'strips', these are bonds that are "stripped" of their interest-paying coupon, then sold separately. The remaining face value of the bond is sold at a discount, giving you an opportunity for higher gains on maturity. These gains are taxed as interest.

Corporate Bonds

Corporate bonds generally offer higher coupon and face value returns since they have a higher risk of default. Your guide to their credit-worthiness are the two rating services in Canada that rate the credit risk of default on all fixed-income investments.

Real Return Bonds

Real return bonds are issued by the Government of Canada. These are bonds that pay a certain percentage of interest (coupon rate) plus the CPI inflation rate. Investing in real return bonds provides investors a guaranteed return above inflation if they are held until maturity. Both the principal and the semi-annual interest are adjusted to the rate of inflation.

Bond Mutual Funds

Just as you would with your equity investments, you can minimize risk and maximize returns in your bond investments by ensuring that you are diversified across bond types. A bond mutual fund offers you the benefits of diversification and access to a wide range of bonds that would be difficult and expensive for you to purchase separately. Bond mutual funds can hold government bonds or corporate bonds exclusively, or may offer a combination of both.

To find out more about bonds and their suitability for your portfolio, call your financial advisor today.

Corporate Bond Ratings

DBRS	CBRS	INTERPRETATION
AAA	AAA	Highest Quality (Investment Grade)
AA	AA	Very Good Quality (Investment Grade)
A	A	Good Quality (Investment Grade)
BBB	BBB	Medium Quality (Investment Grade)
BB	BB	Lower Medium Grade
B	B	Poor Quality
CCC	C	Speculative
CC	D	Bonds in Default
C		Poor Liquidation Values

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