What are bonds?

Bonds are an asset class where the investor lends a government or business money for a set period of time, with the promise of repayment of that money plus interest.

Bonds are a key ingredient in a balanced portfolio. Most investment portfolios should include some bonds, which help balance out risks over time. If stock markets plummet, bonds can help cushion the blow.

Bonds work by paying back a regular amount, also known as a “coupon rate,” and are thus referred to as a type of fixed-income security. For example, a $10,000 bond with a 10-year maturity date and a coupon rate of 5% would pay $500 a year for a decade, after which the original $10,000 face value of the bond is paid back to the investor.

Are bonds a good investment?

Unlike stocks, which are purchased shares of ownership in a company, bonds are the purchase of a company or public entity’s debt obligation. Considered a safer investment than stocks, bonds also generally earn a lower return on your investment. For example, long-term government bonds historically earn around 5% in annual returns. Stocks are more volatile but have earned an average of between 7% and 10% each year.

The more time you have to ride out market fluctuations, the higher your concentration in stocks can be. But as you near retirement and have less time to ride out rough patches that might erode your nest egg, you’ll want more bonds in your portfolio.

If you’re in your 20s, 10% of your portfolio might be in bonds; by the time you’re 65, that percentage is likely to be closer to 40% or 50%.

Another difference between stocks and bonds: The potential tax breaks. Interest payments on municipal bonds (also known as “muni bonds”) are not subject to federal taxes. These bonds are issued by state and local governments to help fund public projects like construction of schools. Muni bonds also may be exempt from state and local taxes if they’re issued in the state or city where you live.

But bonds, like all investments, still carry risks — like the possibility that the borrower will go bankrupt before paying off the debt.

Key things to know about bonds

U.S. government bonds are considered the safest investment. Also known as Treasurys, these bonds are backed by the “full faith and credit” of the United States. Bonds issued by states and local governments generally are considered the next-safest investment, followed by corporate bonds. Bonds are graded by rating agencies such as Moody’s and Standard & Poor’s; the higher the rating, the lower the risk that the borrower will default.

A bond’s interest rate is tied to the creditworthiness of the issuer. Treasurys offer a lower rate because there’s less risk the federal government will go bust. A sketchy company, on the other hand, might offer a higher rate on bonds it issues because of the increased risk the firm could fail before paying off the debt. The rate is fixed at the time of the bond purchase, and interest is paid on a regular basis — monthly, quarterly, semiannually or annually — for the life of the bond, after which the full original investment is paid back.

How long you hold onto a bond matters. Bonds are sold for a fixed term, typically from one year to 30 years. You can sell a bond on the secondary market before it matures, but you run the risk of not making back your original investment, or “principal.” Alternatively, many investors buy into a bond fund that pools a variety of bonds in order to diversify their portfolio. But these funds are more volatile because they don’t have a fixed price or interest rate.

Bonds often lose market value when interest rates rise. As interest rates climb, so do the coupon rates of new bonds hitting the market. That makes the purchase of new bonds more attractive and diminishes the resale value of older bonds stuck at a lower interest rate.

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