4 Questions to Ask Before Buying Bonds

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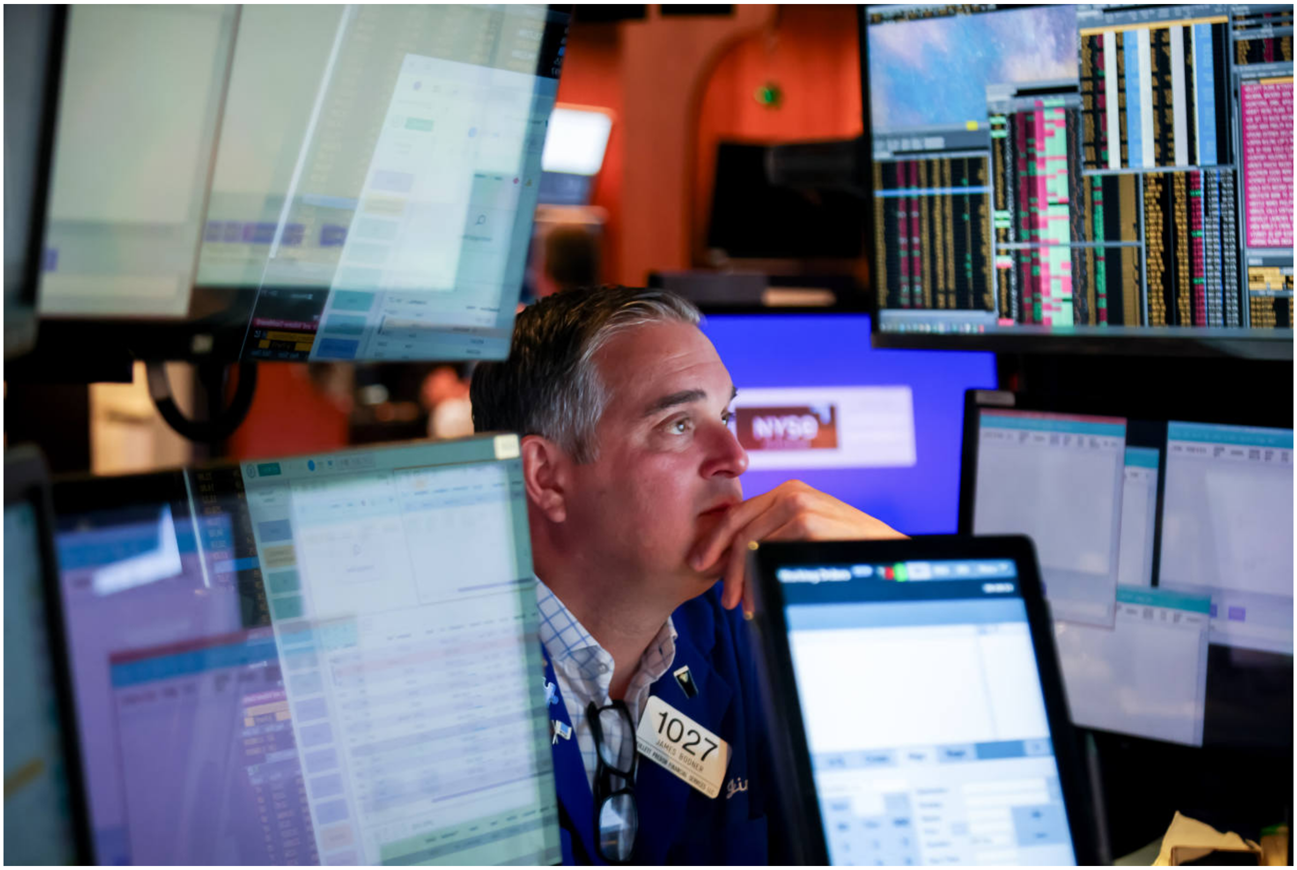
4



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After three years of volatility—driving by inflation and interest rates—bond yields are well off recent peaks. Now with the Federal Reserve expected to cut rates as soon as September, investors face a question: What metrics matter most when deciding where to put their money?

In late August 2022—as the Fed began raising its key short-term interest rates—the 10-year Treasury note yielded around 3%. By October 2023, the 10-year note hit a high of almost 5%, before dropping into the 4% range over the past two years as inflation cooled.

Meanwhile, corporate bond yields have also been volatile. In late August 2022, the yield on the S&P U.S. Aggregate Bond Index, a broad measure of investment-grade bonds, was around 3.9%. By October 2023 it reached 5.8% before falling to 4.5% recently.

Here are some questions bond-market pros say investors should ask when weighing bond investments.

What is the credit rating?

Fixed-income securities carry different levels of credit risk. U.S. Treasurys are considered the world's safest debt because they are backed by the government.

Corporate bonds fall into two broad categories. Investment-grade bonds—rated from triple-A to triple-B—are considered relatively low risk. High-yield or junk bonds are rated double-B or lower, and carry greater risk.

The higher the risk, the greater the chance a bond's price could tumble if the economy turns down. "If you hit a recession and are invested in the high-yield space, then the risk starts increasing," says Thomas Urano, co-chief investment officer and managing partner at Sage Advisory. "Sometimes the price can drop 20-30% without there being a default on the loan payments."

What is the yield to maturity?

Securities move around depending on what's going on in the market and the economy. However, there is a simple trick to determining the return you might expect from an investment in a single company's bond if held for the full term—it's called yield to maturity.

You calculate the yield to maturity by totaling up all the coupons, or interest payments, you are set to receive between the purchase date and the maturity date. Then you add or subtract the price you paid for the bond. If you paid less than the bond's face value, you'll get a gain; vice versa if you paid more than face value. The sum of those two items will help you forecast the expected percentage return when buying the bond.

If it is a zero-coupon bond, which is sold at a discount to the bond's face value, then you receive the face value of the bond. For example, a 10-year zero-coupon 5% Treasury note with a face value would initially cost around $600.

Callable bonds—those that a company can redeem before maturity—require investors to look at the yield to call instead. That is a similar calculation, but the sum of the coupons and the potential capital gain or loss goes only to the call date. For instance, a note issued with 15 years to maturity might have a provision with a call after the first 10 years.

Then there are floating-rate notes, where the bond resets interest rates based on another rate like Treasury bills plus a premium for the riskiness of the borrower. In these cases, you can't calculate the yield to maturity.

What is the duration?

Duration measures how much a bond price will move in response to a 1 percentage-point change in government interest rates.

Bonds with a long time to maturity, usually 10 years or longer, tend to see their price move more than do shorter-dated bonds, says Brian Glenn, chief investment officer at Premier Path Wealth Partners, because their value is based on cash flows further out in the future. A change in rates, then, is applied over a longer period, making longer-term bonds more volatile than shorter-term issues.

Another way bond experts measure duration is by calculating a dollar-weighted average of the bond's payments. Bonds with larger coupon payments generally have shorter durations, since investors recover more of their investment earlier compared with bonds that pay smaller coupons.

Frank McKiernan, co-founder and managing partner at Third View, says it may be worth waiting until bond prices drop before investing. He notes that bond-market prices currently don't indicate that anything is wrong with the economy. However, he figures there are potential issues, such as a recession, that could send bond prices falling.

What does the yield curve look like?

The yield curve reflects the difference in interest rates of different government bonds of different maturities. Most of the time, the yields on long bonds, such as the 10-year Treasury note, are higher than rates on shorter-term bonds such as the 2-year Treasury bill.

Sometimes, however, the rates are the other way around, with the 2-year Treasury bill yielding more than the 10-year note. That is called a yield-curve inversion, and it often signals an approaching economic slowdown.

Bill Stone, chief investment officer at Glenview, notes that an inverted yield curve has been a closely watched indicator of economic slowdown, but that it isn't 100% reliable. If the yield curve inverts, investors should monitor other economic indicators to determine whether the data support the notion of an impending recession. Recently, some observers worried the U.S. might dip into a recession due to the sharp increase in tariffs and inflation that remains above the Fed's 2% target, but so far no recession has arrived.

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