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U.S. SECURITIES AND EXCHANGE COMMISSION

Corporate Bonds

A bond (/investing-basics/investment-products/bonds) is a debt obligation, like an IOU. Investors who buy corporate bonds (/news-alerts/investor-bulletins/what-are-corporate-bonds) are lending money to the company issuing the bond. In return, the company makes a legal commitment to pay interest on the principal and, in most cases, to return the principal when the bond comes due, or matures.

To understand bonds, it is helpful to compare them with stocks. When you buy a share of common stock, you own equity in the company and will receive any dividends declared and paid by the company. When you buy a corporate bond, you do not own equity in the company. You will receive only the interest and principal on the bond, no matter how profitable the company becomes or how high its stock price climbs. But if the company runs into financial difficulties, it still has a legal obligation to make timely payments of interest and principal. The company has no similar obligation to pay dividends to shareholders. In a bankruptcy, bond investors have priority over shareholders in claims on the company's assets.

Like all investments, bonds carry risks. One key risk to a bondholder is that the company may fail to make timely payments of interest or principal. If that happens, the company will default on its bonds. This "default risk" makes the creditworthiness of the company—that is, its ability to pay its debt obligations on time—an important concern to bondholders.

What are the basic types of corporate bonds?

Corporate bonds make up one of the largest components of the U.S. bond market, which is considered the largest securities market in the world. Other components include U.S. Treasury bonds, other U.S. government bonds, and municipal bonds.

Companies use the proceeds from bond sales for a wide variety of purposes, including buying new equipment, investing in research and development, buying back their own stock, paying shareholder dividends, refinancing debt, and financing mergers and acquisitions.

Bonds can be classified according to their maturity, which is the date when the company has to pay back the principal to investors. Maturities can be short term (less than three years), medium term (four to 10 years), or long term (more than 10 years). Longer-term bonds usually offer higher interest rates, but may entail additional risks.

Bonds and the companies that issue them are also classified according to their credit quality. Credit rating agencies assign credit ratings based on their evaluation of the risk that the company may default on its bonds. Credit rating agencies periodically review their bond ratings and may revise them if conditions or expectations change.

Based on their credit ratings, bonds can be either *investment grade* or *non-investment grade (/investing-basics/investment-products/high-yield-corporate-bonds)* . Investment-grade bonds are considered more likely than non-investment grade bonds to be paid on time. Non-investment grade bonds, which are also called high-yield or speculative bonds, generally offer higher interest rates to compensate investors for greater risk.

Bonds also differ according to the type of interest payments they offer. Many bonds pay a *fixed rate* of interest throughout their term. Interest payments are called *coupon payments*, and the interest rate is called the coupon rate. With a fixed coupon rate, the coupon payments stay the same regardless of changes in market interest rates.

Other bonds offer *floating rates* that are reset periodically, such as every six months. These bonds adjust their interest payments to changes in market interest rates. Floating rates are based on a bond index or other benchmark. For example, the floating rate may equal the interest rate on a certain type of Treasury bond plus 1%.

One type of bond makes no interest payments until the bond matures. These are called *zero-coupon bonds*, because they make no coupon payments. Instead, the bond makes a single payment at maturity that is higher than the initial purchase price. For example, an investor may pay $800 to purchase a five-year, zero-coupon bond with a face value of $1,000. The company pays no interest on the bond for the next five years, and then, at maturity, pays $1,000—equal to the purchase price of $800 plus interest, or *original issue discount*, of $200. Investors in zero-coupon bonds generally must pay taxes each year on a prorated share of the interest before the interest is actually paid at maturity.

What happens if a company goes into bankruptcy?

If a company defaults on its bonds and goes bankrupt, bondholders will have a claim on the company's assets and cash flows. The bond's terms determine the bondholder's place in line, or the priority of the claim. Priority will be based on whether the bond is, for example, a secured bond, a senior unsecured bond or a junior unsecured (or subordinated) bond.

In the case of a *secured bond*, the company pledges specific collateral—such as property, equipment, or other assets that the company owns—as security for the bond. If the company defaults, holders of secured bonds will have a legal right to foreclose on the collateral to satisfy their claims.

Bonds that have no collateral pledged to them are *unsecured* and may be called *debentures*. Debentures have a general claim on the company's assets and cash flows. They may be classified as either *senior* or *junior (subordinated)* debentures. If the company defaults, holders of senior debentures will have a higher priority claim on the company's assets and cash flows than holders of junior debentures.

Bondholders, however, are usually not the company's only creditors. The company may also owe money to banks, suppliers, customers, pensioners, and others, some of whom may have equal or higher claims than certain bondholders. Sorting through the competing claims of creditors is a complex process that unfolds in bankruptcy court.

Additional information

Investor Bulletin: What are Corporate Bonds (/additional-resources/news-alerts/alerts-bulletins/what-are-corporate-bonds)
Investor Bulletin: What are High-yield Corporate Bonds (/additional-resources/news-alerts/alerts-bulletins/what-are-high-yield-corporate-bonds)
Investor Bulletin: Interest Rate Risk (/sites/investorgov/files/ib_interestraterisk.pdf)
MSRB Investor Guide 2012 (http://www.msrb.org/Municipal-Bond-Market/Investor-Resources/Investor-Toolkit.aspx)
Bond Funds and Income Funds (http://www.sec.gov/answers/bondfunds.htm)
Callable or Redeemable Bonds (http://www.sec.gov/answers/callablebonds.htm)
Financial Industry Regulatory Authority (FINRA) (http://www.finra.org)
Information on CUSIP numbers (http://www.cusip.com)
Late Payment of Interest on Bonds (http://www.sec.gov/answers/bondint.htm)
Municipal Securities Rulemaking Board (MSRB) (http://www.msrb.org)
MSRB Electronic Municipal Market Access (EMMA) (http://emma.msrb.org/)
The Securities Industry and Financial Markets Association (SIFMA) (http://www.investinginbonds.org)