Stocks vs. Bonds

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Stocks and **bonds** are the two main classes of assets investors use in their portfolios. Stocks offer an ownership stake in a company, while bonds are akin to loans made to a company (a corporate bond) or other organization (like the U.S. Treasury). In general, stocks are considered riskier and more volatile than bonds. However, there are many different kinds of stocks and bonds, with varying levels of volatility, risk and return.

This comparison offers a basic overview of these asset classes and considerations for incorporating them in a diversified portfolio.

Comparison chart

Differences — Similarities —

	Bond	Stock
Kind of Instrument	Debt	Equity
Meaning	In finance, a bond is a debt security, in which the authorized issuer owes the holders a debt and is obliged to repay the principal and interest	In financial markets, stock capital raised by a corporation or joint-stock company through the issuance and distribution of shares
Centralization	Bonds markets, unlike stock or share markets, often do not have a centralized exchange or trading system	Stock or share markets, have a centralized exchange or trading system
Holders	Bond holders are in essence lenders to the issuer	The stock holders own a part of the issuing company (have an equity stake)
Kind	Securities	Securities
Yield Analysis	Nominal yield, Current yield, Yield to maturity, Yield curve, Bond duration, Bond convexity	Gordon model, Dividend yield, Income per share, Book value, Earnings yield, Beta coefficient
Participants	Investors, Speculators, Institutional Investors	Market maker, Floor trader, Floor broker
Issued By	Bonds are issued by public	Stock are issued by corporation

	sectorauthorities, credit institutions, companies and supranational institutions	or joint-stock companies
Owners	bondholders	stockholders/shareholders
Derivatives	Bond option, Credit derivative, Credit default swap, Collateralized debt obligation, Collateralized mortgage obligation	Credit derivative, Hybrid security, Options, Futures, Forwards, Swaps
No. of Types	12 Types	4 Types

Contents: Stocks vs Bonds

What Are Stocks?

Stocks, or shares, are units of equity — or ownership stake — in a company. The value of a company is the total value of all outstanding stock of the company. The price of a share is simply the value of the company — also called market capitalization, or market cap — divided by the number of shares outstanding.

Stocks of a company are offered at the time of an IPO (Initial Public Offering) or later equity sales. Stocks are usually traded on exchanges like the BSE and NSE in India or the NASDAQ and the New York Stock Exchange, which offer great liquidity (i.e., the ability to convert investments into cash as soon as one needs to).

What Are Bonds?

Bonds are simply loans made to an organization. They are a form of debt and appear as liabilities in the organization's balance sheet. While stocks are usually offered only in for-profit corporations, any organization can issue bonds. Indeed, the governments of United States and Japan are among the largest issuers of bonds. Bonds are also traded on exchanges but often have a lower volume of transactions than stocks.

Bonds vs. Stocks

Types of Stocks and Bonds

There are many different kinds of stocks and bonds to choose from, some of which make for more sound investments than others.

Types of Stocks

Stocks fall under two main categories, common stock and preferred stock, and preferred stock is further divided into non-participating and participating stock. The vast majority of investors only buy and sell common stock. Under it, it is easiest to think of stock types according to several primary factors. Good, diversified portfolios include a variety of different types of companies' stocks.

- **Stocks by size:** There are small, medium, and large companies one can invest in. When discussing stocks, they are usually referred to as small-cap (as in market capital), mid-cap, and large-cap companies. Small-cap companies have a market capitalization of $300 million to $2 billion. For mid-cap companies, it's between $2 and $10 billion. Large-cap, or big-cap, companies have a market capitalization above $10 billion. Large-cap companies are usually the most stable; small- and mid-cap companies are considered comparatively riskier to invest in but might offer a better return because of their growth potential.
- **Stocks by sector:** Another way to think of stocks is by sector. Those who care a lot about information technology or some other sector might want to devote a percentage of their investment portfolio to such companies. Standard & Poor's (i.e., the S&P500) organizes stocks it follows into 10 major sectors and even more industries, making it easy to do this (see the Global Industry Classification Standard or this list of S&P 500 companies). When investing by sector, it is important to invest in a variety of sectors and industries to lower risk.
- **Stocks by growth:** Some stocks are rapid growers and have the potential to give a good return, but they can be risky; these are growth stocks. Value stocks are those that are more stable within the market and are likely to give some return overall but are not as likely to have major spikes or dips in value.
- **Stocks by region:** It is possible to invest in local and overseas markets. Investing in an international fund will allow one to put money into stable markets (e.g., Western Europe's), riskier emerging markets (e.g., Latin America's), or a combination of both.
- **Index funds:** If picking and choosing stocks by the above factors seems overwhelming or like it is too much trouble, index funds can be a good investment alternative. The NASDAQ-100 is an example of a stock index; in its case, it lists the top 100 large-cap stocks in the NASDAQ. When an investor puts his or her money in a NASDAQ-100 index fund, the money is evenly divided between all the stocks within the fund. The idea behind an index fund is that, on the whole, the entire index will grow and produce a return, though some stocks within the fund may decrease in value. Compared to some other methods, especially for inexperienced investors, index funds can be a relatively low-risk way to invest in the stock market.

Types of Bonds

The bond market, which is also sometimes known as the debt or credit market, allows investors to issue new debt in what is known as the primary market and buy and sell debt securities in the secondary market.

- **Government bonds:** Bondholders of government bonds are loaning money to a government. Provided the government one invests in does not default on this type of loan (unlikely in established nations), the principal of a bond is paid back in full over time, with interest. In the U.S., there are several types of government bonds, known as "treasury securities." The main three — treasury bills, treasury notes, and treasury bonds — mature at different rates and pay interest in different ways; they require a minimum investment of $100. Other types of government bonds may be cheaper to buy but tend to result in a lower return. There are also floating-rate notes that offer a variable rate of interest according to the market.

Finally, it is possible to invest in other countries' bond markets. Investing in established countries is very safe but unlikely to yield a significant return, while investing in developing countries is risky but could prove profitable.

- **Municipal bonds (a.k.a., "munis"):** The word "municipal" relates to smaller, local governments, like those which govern towns, counties, cities, or states — i.e., not national/federal governments. Just as investors can loan money to federal governments, so, too, can they loan money to local governments, usually to help fund specific public projects, like water/sewage upgrades, hospitals, schools, etc. While many local governments around the world issue municipal bonds, the U.S. municipal bond market is the largest and is considered to be one of the safest.
- **Corporate bonds:** As the name suggests, corporate bonds are where investors loan money to corporations. They make for riskier investments than government and municipal bonds, but the potential returns are much higher. To avoid investing in high-risk corporate bonds, investors use bond ratings provided by organizations like Standard & Poor's and Fitch Ratings. Bond ratings are what they sound like: they rate the creditworthiness of a corporation.
- **Zero-coupon bonds (a.k.a., accrual bonds):** These bonds are often sold at a discount and have a fixed interest rate that only pays out upon bond maturity. In other words, there are no periodic interest payments from these bonds; instead, the interest accrues, or builds up, over time. While these can make for a good investment, there are drawbacks in terms of how they are taxed.

Stocks and Bonds to Avoid

- **Penny/cent stocks:** The U.S. Securities and Exchange Commission (SEC) defines a penny stock as generally being "a security issued by a very small company that trades at less than $5 per share." These stocks are not traded on major stock exchanges and may be very difficult to sell once owned. It is relatively easy for one to lose all of the money he or she invests in penny stocks.
- **Junk bonds:** This is the name given to high-risk bonds from companies (or governments) that receive lower bond ratings and have a greater chance of defaulting. Junk bonds should generally be avoided by most investors, as there is a very good chance that one will see *no* return and perhaps even lose money. However, some more aggressive investors still choose to occasionally invest in them.[1]

How Are Stocks and Bonds Valued?

The price of a stock is determined by what buyers and sellers on the exchange are willing to pay/accept on any given day. In general, the value of a company is determined by the value of its assets (minus liabilities), along with the net present value of all future earnings. A key factor in determining value is the expectation of growth. If investors expect a company to grow very fast in the future, they may value the company highly even if it is currently a loss-making enterprise. Companies like Twitter and Amazon are examples of cases where the current earnings may be small — or even negative, i.e., losses — but the value of the company's assets (such as intellectual property, its customer base, brand, goodwill, and other intangibles) and the expectation of future growth is so high that the company is valued at billions of dollars.

Every investor has her own opinion of the value of the company. Share price reflects a sort of consensus opinion of the market.

With bonds, prices are determined based on how ratings companies, like S&P and Fitch, rate the creditworthiness of the issuer of the bond. For example, a corporate bond issued by Apple is rated AAA, which means the ratings agency has very high confidence in the ability of Apple to repay its loan, the bond debt that the bondholders own. The likelihood that Apple will default on its loans is very low, so the company can borrow at very low interest rates (say, 2%).

Bond Yields vs. Prices

A confusing element of bonds is that they have two types of valuations, a daily value, price, on the bond market, where bonds can be bought and sold, and a long-term return value, yield (or, more often, yield to maturity), where investors earn back the principal cost of the bond, plus interest, plus/minus any gains or losses.

Bond prices have a unique relationship with bond yields. Specifically, when the price of a bond goes up on the bond market, the yield of that bond decreases; or when a price decreases, a yield increases. For more vigilant and active investors, both concepts are useful. To see an example of how prices and yields relate to one another, watch the video below.

Treasury Bond Prices and Yields

External Factors

Factors external to the organization also affect the price of its shares and bonds. For example, when the economy is weak and stagnating, all share prices tend to fall because the expected value of future earnings is lower. Conversely, when the economy is growing, and unemployment is low, investors are more confident.

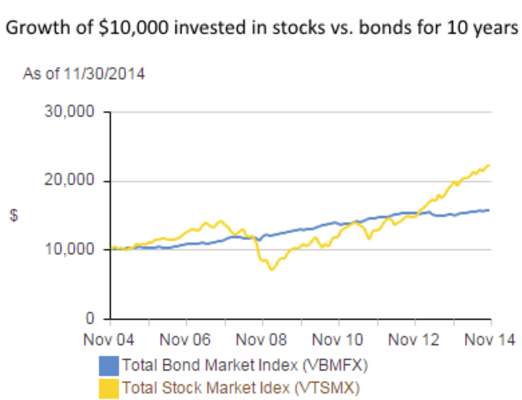
Another factor is money supply. When interest rates are lowered — like, the Federal Reserve did in the aftermath of the 2008 financial crisis — two things happen that inflate share prices:

1. There is more money in the financial system. More money in circulation increases inflation and fuels a rise in share prices.
2. "Safer" options to invest money in debt (bonds) become less lucrative when interest rates fall. So investors choose stocks to chase higher returns.

Building a Portfolio

Risk and Performance

In general, stocks are considered riskier and more volatile than bonds. However, stocks are also believed to offer a higher return compared with bonds. This chart compares the returns from stocks vs. bonds over a 10 year period and represents the conventional thinking around stock vs. bond performance:



Growth of $10,000 invested in Vanguard's index funds for the total stock market (VTSMX) and the total bond market (VBMFX), over 10 years.

A big caveat to a chart like this is that it can look very different depending upon the time period. For example, if the 10-year chart were to end in 2008 then the total return for stocks may well have been negative.

It is important to understand that stocks are often *very* long-term investments (10+ years), usually for retirement purposes. In any given year, a stock can have steep highs and deep lows as its value is redefined again and again on the market, making frequent buying and selling extremely risky and mostly inadvisable. Over time, though, stocks tend to return 6-7% annually, on average, after adjusting for inflation and dividends. [2] [3]

Graphs showing the NASDAQ, Dow Jones, and S&P 500 stock indexes over time. Notice the ups and downs but general trend toward growth.

Bonds are also used for retirement savings, but shorter-termed bonds — those which mature within 10 years or fewer — can just as easily be used throughout a lifetime for small, periodic returns. Long-term (e.g., 30-year) U.S. Treasury bonds usually have a return of around 3-4%.[4]

Allocation

First-time investors often want to know how much money they should allocate to stocks and how much they should allocate to bonds. The answer is *it depends*. What it depends on is risk tolerance, which changes with age; ability and know-how when it comes to risk-taking strategies; and how much liquidity is needed. There are numerous strategies one can use to invest:

- *Simple approaches:* John Boglehead, of Bogleheads fame and the founder of the Vanguard Group, recommends a simple approach to investing, wherein one invests in two index funds, a U.S. total market index fund and a U.S. total bond market fund. Investing in a third group of international stocks or bonds is also often recommended. This easily makes stock investment a near "set it and forget it" sort of experience. *See also ETF vs Mutual Fund.*
- *More complex approaches:* Younger people can take on more risk than older people because they have time to recoup any significant losses. Some advocate that those who are younger should take greater risks and invest much more in the stock market than in bonds, while those who are older should cut down on their risks and invest more in bonds and stocks that are thought to be safer, though stocks should still make up the majority of a portfolio. Some also recommend investing small amounts in real estate (REIT).

Charley Ellis: Stocks vs Bonds What % of Each

Diversifying Stock and Bond Portfolios

Diversification reduces risk.[5] Those who decide to invest manually in the stock market, rather than use index funds, must learn to diversify their portfolios themselves. Just because an investor is interested in or knows a lot about the energy industry does not mean he or she should only invest in it. A person who only owns stock in one company or industry is at much greater risk of losing money than a person who invests in multiple companies and industries and different kinds of bonds. The investor should buy a wide variety of stocks and bonds using some of the factors listed above.

Investment Tools and Fees

When it comes to investing, the old adage is somewhat true: one has to have money to make money. Investing a small amount in a single company is less wise than saving up and then investing a larger amount in index funds or across several types of companies and bonds; most brokerage accounts require at least $500 to start.

First-time investors should also be prepared for fees. Brokerage accounts charge account fees and/or trading fees. Others have different business models that charge flat percentage fees.

Some common investment tools and trackers include the following:

- Charles Schwab
- E*TRADE
- Fidelity
- Mint
- Personal Capital
- Scottrade
- TD Ameritrade
- The Vanguard Group

Several other comparisons are relevant to the buying and selling of stock: Ask Price vs Bid Price, Call Option vs Put Option, Futures vs Options, Forward Contract vs Futures Contract, Limit Order vs Stop Order, and Naked Short Selling vs Short Selling.

Shareholders vs. Bondholders

Shareholders have different investment rights from bondholders. As part owners of a company, shareholders get a say in how a company is run, while bondholders, as lenders, have no say in how governments or corporations manage themselves or their loan. In the case of a company liquidating, however, bondholders come out on top, with their investment receiving priority over shareholders' investments.[6]

Voting Rights

A benefit of owning stock is the ability to participate in companies' affairs. Shareholders have the right to look at a company's records, attend (or listen to) annual meetings about company performance, receive a cut of all declared dividends, participate in electing directors to the board, and sue the corporation for any infringing behavior.[7] There is really no eqvuivalent set of rights for bondholders.

Those with a large stake in a company will often take advantage of their rights as shareholders to help guide a company toward (hopefully) more growth. For example, voting rights are especially important, as a company's board of directors greatly affects how well a company will perform in the future.

Liquidation and Bankruptcy

Sometimes companies fail and have to close down or reorganize. When this happens, they may begin a process of liquidation — that is, selling assets to pay off debts — which is part of Chapter 7 bankruptcy in the U.S. Debts are always paid off first, meaning bondholders have an advantage over shareholders when it comes to liquidation. Shareholders receive any money that is left over from debt repayment, which may not be any at all. This is one of the biggest reasons bond investments are safer than stock investments.

Different types of bankruptcy, such as Chapter 11, affect bondholders and shareholders in different ways than the above, but generally bondholders come out on top when compared to shareholders. Neither are very likely to get back all of their investment, however, which proves yet again the importance of careful investment.

How Stocks and Bonds Are Taxed

Different types of stocks and bonds are taxed differently. In some cases, even, one state may tax interest than another does not. Sometimes federal taxes apply, and other times they do not.

In general, though, the following is true for bond taxation:

- Interest earned from U.S. Treasury bonds and savings bonds — i.e., federal government bonds — is only taxed at the federal level. State and local governments do not tax this money.

- Corporate bond earnings are taxed at every level. They are taxed the most of all bonds because their returns are usually the highest.
- Earnings gained from municipal bonds are taxed in a complicated fashion. Sometimes federal, state, and local taxes apply; other times, none apply. For a thorough explanation of how municipal bonds are taxed, see this Investopedia article.
- Though zero-coupon bonds do not pay out interest over time, but rather accrue it until bond maturity, federal, state, and local taxes apply to this interest that is sometimes called "phantom" interest.[8]

And what follows here is generally true for stock taxation:

- Stocks that are sold within a year of their purchase are subject to short-term capital gains taxes — that is, whatever the investor's normal income tax rate is.

- It is better to hold on to stocks for at least a year before selling, as earnings then are subject to long-term capital gains. For those whose income is taxed at 10-15%, the long-term capital gains tax is 0%.[9]
- Any earnings from stock dividends are also taxable. They are taxed in the same way that the bought and sold stocks are. In other words, dividends earned from a long-held stock are more lightly taxed than those earned from a recently-owned stock.

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Related Comparisons

ETF *vs* **Mutual Fund**

Common Stock *vs* **Preferred Stock**

Limit Order *vs* **Stop Order**

E*TRADE *vs* **Scottrade**

Futures *vs* **Options**

Chapter 11 *vs* **Chapter 7 Bankruptcy**

Comments: Bond vs Stock

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诗璇 · Tunku Abdul Rahman University College

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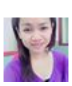

Vannet Kong · Accounting Executive-Finance at Bureau Veritas Cambodia Ltd

Could u advice me, between Stock & Bond, which one is better to invest in?

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Tak Smann · National Economic University

Stock is risker than bond and stock also earns money

Anonymous comments (3)

June 19, 2013, 9:45am

its very clear to understand

— 59.*X*.*X*.102

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How do I go about investing

— 66.*X*.*X*.23

much more than bond.

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Amos Kwarm · Sub- Metro Internal Auditor at ACCRA METROPOLITANT ASSEMBLY

as an investment adviser would you invest in bonds or shares?

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Suman Das

Whether bonds or stocks, they are used for making money.

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Edwin Mandizvidza · Makumbe mission buhera

its difficult to say which is better than the other bond or loanstock. the answer lies in the economic environment an entity is operating under. these may be favourable or unfavourable for an entity to go for a bond or a loanstock. it is noteworthy to consider that some industries are counter-cyclical.

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simple presented

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so! bonds are safer than stocks!

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> **Shah Fahad** · Aga Khan Higher Secondary School Gilgit
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> if we talk about which is safer, bonds or stocks?none is safe because if a company is unable to repay the bond holder in any case than how the bond is safe?? so no safety is 100%
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like really impressive......... now know the deference between stork market and the fixed income market

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I think both are good, but my percentage for bonds is 45% whiles stocks is 55%.

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simple but practical comparison...i will be using this for my lecture.

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>
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> i agree, its less risky..those who prefer stocks wants prestige of being a part owner of a corporation..
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great help

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Ahmad Allemyar · Andhra University

it was great description. thank you very much.

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After reading this, i clearly understood the differences. Moreover, this is very user friendly and easy to view. :)
Thanks.

— 122.X.X.98

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