Bonds, Mutual Funds, Stocks

What is a bond?

A bond is simply a certificate which the borrower promises to repay within a certain time period. For the privilege of using the money, the government entity, municipality or company will agree to pay a certain amount of interest per year, usually an exact percentage of the amount loaned.

Bondholders do not own any part of the companies they lend to - they do not receive the benefits of dividends or the privilege to vote on company matters as stockholders would, and the success of the investment isn't related to that company's record in the market either. A bondholder is entitled to receive the amount that was agreed upon, as well as the principal of the bond.

Corporate bonds are generally issued in the denominations of $1000. This price is referred to as the face value of the bond; this is the amount that is agreed to be paid by the company at the time that it matures. Bond prices can differ from their face values, because the prices of the bonds are correlated to the current market rates. When these rates change, the value of the bond will as well. If one were to sell the bond before the time that it matures, the bond may be worth less than was initially paid. A callable bond is one that the issuer may choose to buy back at full face value before the maturity date. There are three major features of bonds:

- Issuing Organization
- Maturity
- Quality

Short Term Bonds mature in two years or less and long-term bonds mature in ten or more. Intermediate is between two and ten years.

What is bond quality?

Bond quality is the rating of the creditworthiness of an issuing organization. There are organizations that specialize in judging bond quality. The higher the rating, the lower the risk of the investment. The rating system uses letters A through D. The only bond considered to be risk free is the U.S. Treasury Bond.

How does the bond rating system work?

Highest Quality	Moody's	Standard & Poor's
High Quality	Aaa	AAA
Good Quality	Aa	AA
Medium Quality	Baa	BBB
Speculative Elements	Ba	BB
Speculative	B	B
More Speculative	Caa	CCC
Highly Speculative	Ca	CC
In Default	----	D
Not Rated	N	N

How do interest rates affect bond prices?

Generally bond prices and interest rates have an inverse relationship - as interest rates drop, bond prices rise and vice versa.

How does maturity affect bond prices?

Bond prices are heavily influenced by maturity; the longer the maturity, the greater the change in price for a change in interest rates. If interest rates rise, it would make a larger difference in the 20 year bond, as opposed to a 10 year bond. Because of this, bond fund managers will attempt to change the fund's average maturity to anticipate changes in interest rates.

What is a bond call provision?

A "call" is when the issuer of the bonds has an opportunity to redeem the bonds after a certain specified amount of time has passed. This doesn't guarantee a continuation of a high yield after the call date - it limits the appreciation of the bonds, and it makes the investment more risky. These call provisions can be complex, so it is best for investors that don't have strong knowledge to avoid bonds with a call feature.

Should I buy bond funds directly or go through a mutual fund?

A bond mutual fund has within it multiple bonds, and for that reason it is impossible to lock in the payment rate or the principal, which you would be able to do if you were directly buying a fund. A bond mutual fund is an investment company which manages a portfolio of individual bonds. The investors buy ownership in the company, and each share represents ownership in all of the company's holdings. Managers will use these investments to buy and sell bonds that align with the objective of the fund. Because a bond fund manager has more resources to deal with, they can invest in a vast array of bonds - many more than could any individual investor. There are also certain investments that cost tens of thousands of dollars a share - a bond fund costs far less. Liquidity plays a major role in bond buying. If you purchase a bond individually and wish to sell it, you must find a buyer for your bond, but if you are invested in a bond fund, that fund has to buy your shares back at any time you wish.

Continued on other side →

Bonds, Mutual Funds, Stocks (cont.)

What are the different issuing organizations for bonds?

- Municipal bonds are offered by local governments, states and cities. The interest of these bonds is not subject to federal income tax, and if the bondholder lives in the jurisdiction of the governing authority, the interest is exempt from state and local tax. Because of all of these tax advantages, the interest rates paid on these bonds is usually lower than others.
- Like municipal bonds, the U.S. government also issues these securities. Since they are issued by the U.S. Government, they are considered to have the best safety of all bonds.
- Treasury bills can be bought through a broker or directly from the Federal Reserve.

How are <u>mutual funds</u> taxed?

All mutual funds distributions should be reported as income, whether you reinvest or not. Taxable distributions come in two forms, ordinary dividends and capital gains. The distributions of ordinary dividends represent the net earnings of the fund and are paid out periodically to the shareholders. Since these payments are considered to be dividends to you, they must be accounted for accordingly.

Capital Gain Distributions are the net gains of the sales of securities in the fund's portfolio and will be taxed at a different rate than that of ordinary dividends. Yearly, your mutual fund will send you a form, called the 1099-DIV, which will have a detailed breakdown of all of these.

Can I avoid tax by reinvesting mutual fund dividends?

Funds will generally give you the opportunity to automatically reinvest in the fund. This does not prevent you from paying tax on your assets, but this reinvestment will prevent you from paying more "buy" fees to get into the fund, so it is advantageous.

What taxes apply to my return-of-capital distributions?

Mutual funds sometimes will distribute back to shareholders monies that haven't been attributed to the fund's earnings. This is a non-taxable distribution.

How does <u>stock</u> trading work?

Stocks are traded in quantities of 100 shares, called round lots. Any quantity of stock under 100 shares will be considered an odd lot.

What is the difference between Preferred and Common Stock?

Most stocks are common stocks. However, there is another type (known as preferred) which gives certain advantages regarding dividends. Generally, preferred stockholders do not have the same voting rights that the holders of common shares do. Common stocks are based on company performance, while preferred stocks will usually have a stated dividend.

How can I invest in foreign stocks?

It is fairly easy to invest in foreign corporations, because these corporations need to register these securities with the SEC. These companies are subjected to the same rules as U.S. companies.

To access additional articles go to www.vta.com website and choose Financial Guides.