FINDING A BOND: WHERE TO START

Finding a bond that's right for your portfolio doesn't have to be difficult. Go through this checklist to find helpful tips on knowing which bonds could be a good fit.

There are two big drivers of bond prices: interest rate sensitivity and credit quality

Interest rate sensitivity

- This refers to how much a fixed-income asset price moves with changes in interest rates. This is because interest rates and fixed-income asset prices are inversely correlated.

Credit quality

- Is a measurement of a company's ability to repay its outstanding debts. Credit quality is an indicator of credit risk and refers to the perceived risk of a bond falling in price. This is one of the principal criteria used for judging the investment quality of individual bonds as well as bond funds.

Bond maturity determines interest rate sensitivity

- The longer the maturity, the longer investors' dollars are tied to a fixed interest rate
- Yield is income received divided by the price paid for the bond
- Falling rates reduce yield (higher prices are paid for bonds with larger relative coupons)
- Rising rates raise yield (lower prices are paid for bonds with smaller relative coupons)
- Duration shows how sensitive a bond's price is to interest rate changes
- A rule of thumb is a bond's price will move by 1% times a bond's duration for every one percentage point move in bond prices (e.g., if interest rates rise from 1% to 2%, bond with a five-year duration will decline by 5%)

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A few important aspects of credit quality include:

- Credit quality refers to the perceived risk of a bond falling in price
- Investment Grade:
    - AAA/Aaa to BBB/Baa
- Non-investment Grade:
    - BB/Ba to D (C for Moody's) - also known as high-yield or junk bonds
- The worse the credit rating, the higher the yield investors will demand as compensation

Now, it's time to consider taxes on certain types of bonds!

- Treasury bonds:
    - Interest is exempt from federal taxes
- Municipal bonds:
    - Interest is generally exempt from state, local and federal income taxes; consider
- Corporate bonds:
    - Interest is fully taxable

Other important notes about taxes on bonds:

The tax equivalent yield can be used to compare muni bonds against Treasury and corporate bonds:

- Tax-exempt yield ÷ (1 – Your marginal tax rate)
- Municipal bond interest influence Medicare Part B premiums and taxation of Social Security benefits

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Before you choose to invest in bond funds, you will want to know that:

- Higher returns and yield can be the result of the manager taking on more credit risk relative to peers
- The category risk ratio, available in the AAII Mutual Fund and ETF guide, can tell you which funds are more volatile
- Expenses matter just they do for stock funds
- Can distribute both taxable income and taxable capital gains distributions; use our guides to review the tax cost ratio

Lastly, you'll want to understand its impact on your overall allocation:

- Corporate bonds and bond funds should be held in tax-preferred accounts like IRAs and 401(k)s
- Muni bonds are best suited for taxable accounts in order to realize the tax equivalent yield

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