No-Frills Money Skills Video Series

Episode 4: Understanding Bonds (12:44)

View Episode 4 at https://www.stlouisfed.org/education/no-frills-money-skills-video-series/episode-4-understanding-bonds.

1. **What is a bond?**

   A bond is a debt instrument—like an IOU—issued by a government or corporation. When you buy a bond, you are lending money to a government or corporation.

2. **What is the relationship between bond prices and interest rates?**

   Bond prices move opposite the market interest rate. For example, when the interest paid on other investments rises relative to the interest paid on bonds, bondholders may want to sell their bonds and invest the money elsewhere to earn higher interest. To attract buyers, bond prices will likely come down. Lower bond prices in effect increase the yield on bonds.*

3. **What are some primary differences between newly issued coupon and zero-coupon bonds?**

   A coupon bond is sold at its face, or par, value, and interest is paid to the bondholder for a set time (usually semi-annually or annually) until the bond matures. When the bond matures, the bondholder receives the initial investment back along with the final interest payment. Many bondholders use interest payments as income.

   A zero-coupon bond is sold at a price lower than its face value; the bondholder receives the face value when the bond matures. Thus, with a zero-coupon bond, all of the return (interest) is received at maturity.

4. **Based on the risk-reward pyramid of investment, give two examples each of investments with potentially low, medium, and high risk and corresponding potentially low, medium, and high reward.**

   Low: Treasury securities or government bonds, certificates of deposit (CDs), savings accounts, cash, and checking accounts

   Medium: Stocks, mutual funds, and corporate bonds

   High: Commodities, antiques and collectibles, and real estate

5. **Explain why FDIC-insured savings and checking accounts do not offer a high potential for reward.**

   Because these types of accounts are insured, they are very low risk.

*Say you buy a 5-year coupon bond for $1,000 that pays 5 percent annually, or $50. At the end of 5 years, when the bond matures, you will receive the final $50 payment plus the $1,000 you paid for the bond. So, the yield on this bond is 5 percent per year. Say, though, that three years after you buy the 5-year coupon bond, some other bonds and other financial instruments are paying 6 percent interest. To earn a higher yield for your money, you want to sell your bond and invest the money elsewhere. Because investors can earn more than the 5 percent annual interest the bond pays, you will have to reduce the price below the $1,000 face value to attract a buyer. At a lower price, the $50 annual payment will provide a higher yield relative to the purchase price of the bond. For example, if the $1,000 bond is purchased for $950 with two years left to maturity, the buyer will receive 7.8 percent interest over the remaining life of the bond.