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The Role of Bonds

Bonds: A Primer

Bonds are a type of investment that belong to the asset class known as Fixed Income. This is a broad category of investments where an investor, the buyer, lends money to a borrower, the issuer, in exchange for a series of interest payments for a set amount of time and the return of principal at maturity. The bond itself is simply a contract outlining these terms.

Bondholders are creditors, not owners, and they have priority in a company's capital structure (meaning they are among the first to be repaid in the event of a default).

Risk levels can vary significantly depending on the issuer, a bond's structure, and overall market conditions. These factors affect the amount of interest a bondholder expects to receive from any given bond. Like all investments, there is a correlation between risk and return.

The Strategic Benefits of Bonds

Bonds serve multiple strategic and important functions for both buyers and issuers:

- For buyers, bonds provide both income and portfolio diversification:
  - Bonds provide a predetermined stream of interest payments, often essential for meeting investors' cash flow needs. Principal is returned when the bonds mature.
  - High-quality bonds are viewed as a less risky portion of a diversified portfolio since they are typically less volatile than equities and are more liquid than most alternative investments.
- For issuers, bonds provide funding:
  - Governments (federal, state, county, and towns) and corporations issue bonds for a wide variety of purposes, including building roads, schools, and expanding their businesses.

Common Types of Bonds

- **U.S. Treasuries**: Considered the lowest risk. U.S. Treasuries are issued and backed by the full faith and credit of the U.S. government. U.S. Treasuries are taxed only at the Federal level.

- **Municipal Bonds**: Issued by states, cities, and other local governments and entities. Interest on municipal bonds can be triple tax-free (federal, state, and local).
- **Government Agency Bonds**: Issued by U.S. government agencies like the Federal Home Loan Bank and FNMA (Fannie Mae). These bonds may be exempt from state and local taxes.
- **Corporate Bonds**: Issued by companies to raise money for business needs. These usually offer higher interest rates than government bonds but may also come with more risk. Corporate bonds are fully taxable.

Risks of Owning Bonds

While bonds are generally considered safer than stocks, they do come with risks. The primary concern is that the issuer might not be able to make interest payments or pay back the principal when the bond matures. This is called default risk.

Default risk is lowest for issuers with the highest quality credit. In the event of a bond issuer's default, bondholders, as creditors, typically have priority in claiming the issuer’s assets. This can offer some protection, but it doesn’t always mean you’ll get all your money back. The only type of fixed income that carries some form of “insurance” would be CD’s, where principal under $250,000 is protected by the FDIC.

What Does "High-Quality Credit" Mean?

The term ‘high quality’ refers to the creditworthiness of the issuer and their ability and likelihood to meet debt obligations. Every bond carries some risk of default, and ratings agencies like Standard & Poor’s (S&P), Moody’s and Fitch assign grades based on each issuer’s creditworthiness. Here is how each agency rates ‘higher quality’ (also referred to as ‘Investment Grade’):

- S&P: ratings of BBB- to AAA.
- Moody’s: ratings of Baa3 to Aaa.
- Fitch: ratings of BBB- to AAA.

Bonds with ratings below these levels are considered ‘non-investment grade’ or ‘junk’ bonds which carry higher risk.

Unlike equities, which represent ownership in a company and have values that fluctuate with business performance and market valuation, ‘high-quality’ bonds offer more predictable outcomes.

The risk of any fixed income investment is influenced by several factors, including a borrower's creditworthiness and interest rate sensitivity. Thoughtful analysis is essential to evaluate underlying risks, understand potential return outcomes, and ensure that each investment aligns with an investor's goals.

The Role of Bonds in a Portfolio

High-quality bonds can be a cornerstone of a well-constructed and balanced portfolio. For many investors, particularly those nearing or in retirement or with a lower risk-tolerance, high-quality bonds can provide predictable income and portfolio stability. They can serve as a reliable funding source for withdrawals or specific income needs, while also acting as a buffer during equity downturns. The inclusion of bonds in a portfolio doesn't follow a one-size-fits-all model, it reflects each client's personal investment strategy.

At PSG, we focus on what matters most to our clients, whether it is capital preservation, generating income, long-term growth or some combination. We work with you to ensure that your investment plan is aligned with your long-term objectives.

Have questions? Let's talk.

We would love to work with you to build the right fixed income strategy for your needs.

Email investors@psgwealth.com or call us at (914) 288-4900 to discuss!

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