PIMCO

INVESTOR EDUCATION

Introduction to Bonds

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What is a Bond?

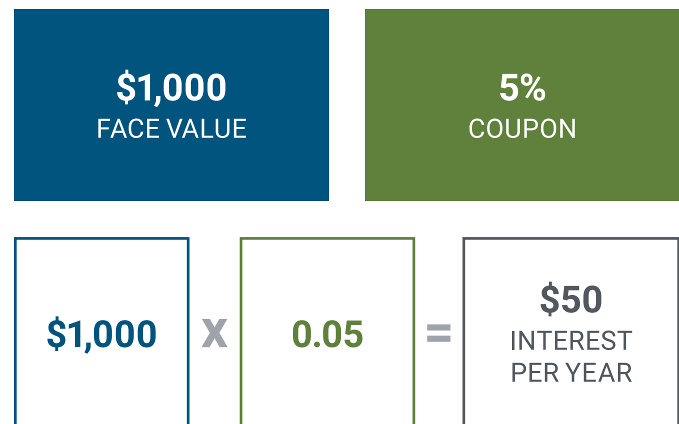
Bonds are basically loans. A company, state or government issues bonds to raise money. When an investor buys a bond they give the issuer – the company or government who issued the bond – a loan. Often, the bond issuer agrees to pay its investors periodic "fixed" interest payments (hence the name fixed income) while the loan is outstanding and to pay back the full loan at the end of the bond's life (called maturity).

The amount that is given to the issuer is called the principal, or face value, of the bond. In return, the issuer agrees to pay the investor both the face value of the loan on a specific date (the "date of maturity") and to pay the investor periodic interest payments, known as coupons, in specific intervals.

The coupon is periodic interest payment that the bond holder receives from the issuer from its issue date until it matures. The coupon rate (expressed as a percentage) is calculated by adding the sum of coupons paid per year and dividing it by the bond's face value. Often coupons are paid semi-annually.

Unlike stocks, bonds issued by companies do not generally give investors ownership rights. Instead, bonds provide a stream of income. When held in a portfolio with stocks, bond investments can offset some of the volatility in the equities market.

If a bond has a face value of $1,000 and a coupon rate of 5% then it pays total coupons, or interest, of $50 per year (assumes annual payment)



Hypothetical Example for Illustrative Purposes Only

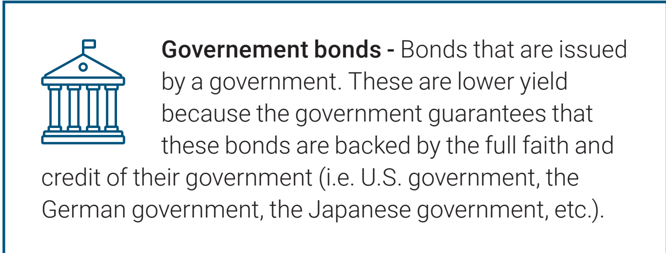
WHAT IS THE DIFFERENCE BETWEEN "YIELD" AND "INTEREST RATE"?

You'll hear the word "yield" often when discussing bonds. It's a measure of interest that takes into account the bond's fluctuating changes in value and is usually reported as an annual percent figure.

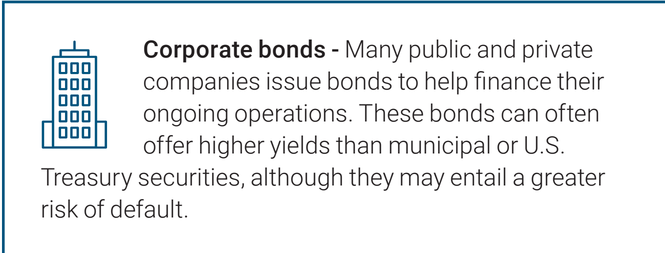
Yield is the annual net profit that an investor earns on an investment. The **interest rate** is the percentage charged by a lender for a loan. The **yield** on new bonds reflects **interest rates** at the time they are issued.

What Types of Bonds are There?

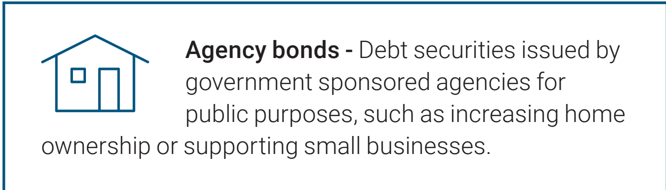
Bonds can be issued by companies or governments when they want to raise money. There are several types of bonds, including:



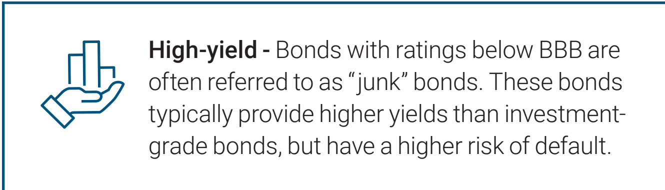
Governement bonds - Bonds that are issued by a government. These are lower yield because the government guarantees that these bonds are backed by the full faith and credit of their government (i.e. U.S. government, the German government, the Japanese government, etc.).



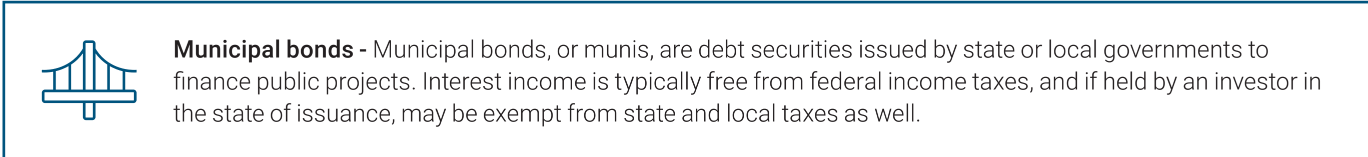
Corporate bonds - Many public and private companies issue bonds to help finance their ongoing operations. These bonds can often offer higher yields than municipal or U.S. Treasury securities, although they may entail a greater risk of default.



Agency bonds - Debt securities issued by government sponsored agencies for public purposes, such as increasing home ownership or supporting small businesses.



High-yield - Bonds with ratings below BBB are often referred to as "junk" bonds. These bonds typically provide higher yields than investment-grade bonds, but have a higher risk of default.

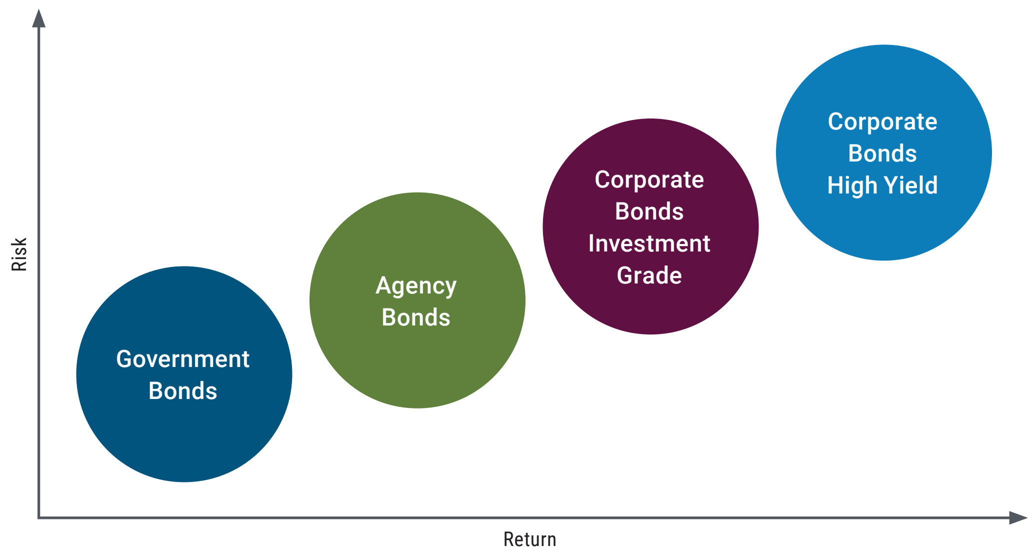


Municipal bonds - Municipal bonds, or munis, are debt securities issued by state or local governments to finance public projects. Interest income is typically free from federal income taxes, and if held by an investor in the state of issuance, may be exempt from state and local taxes as well.

The global bond market is very diverse, and offers a range of risk and return opportunities.

On one end of the spectrum, there are lower yield government guaranteed bonds backed by the full faith and credit of a government, and on the end there are higher yielding bonds issued by speculative grade companies that may potentially experience some default of interest or principal.

Investors want compensation for taking on more risk

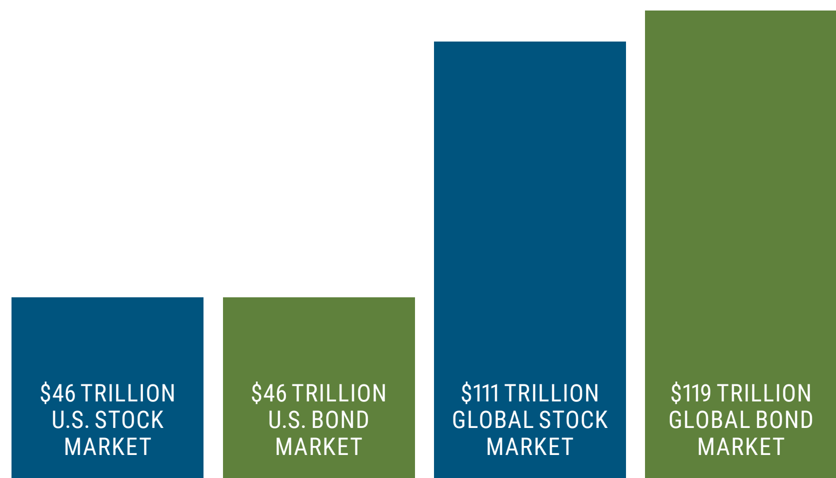


For illustrative purposes only

Source: PIMCO.

How Big is the Bond Market?

Many investors don't realize just how large the bond market is. At $46 trillion, the US bond market is comparable in size to the US stock market. At $119 trillion, the global bond market is even larger.[1] You may wonder why the bond market is so large. This is in part because governments issue bonds, not stocks. For companies, bond financing can also be a more attractive source of financing.



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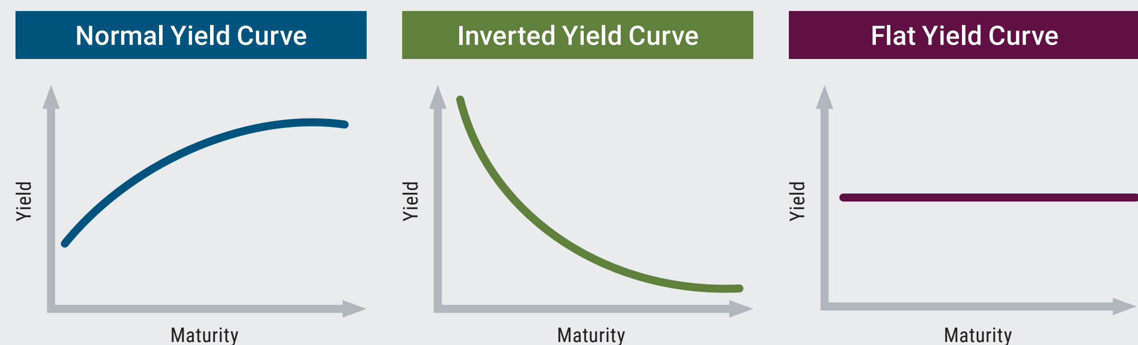
WHAT IS A YIELD CURVE AND WHAT DOES IT MEAN FOR ME?

The yield curve plots the interest rates for similar quality bonds against their maturities (years to expiration). There are three main types of yield curve:



Normal Yield Curves are seen during typical periods of economic expansion. The curve goes up from left to right. This upward slope indicates market participants believe rates are likely to go up – remember that if rates go up bond prices go down and yields go up.

An **Inverted Yield Curve** is seen during times of anticipated economic slowdown and in the past has been rare. The curve is inverted from a normal curve, it indicates market participants expect rates to go down, pushing bond prices up and yields down.

A **Flat Yield Curve** may be seen when the economy is in transition, so from expansion to slowdown or visa versa. It shows a relatively flat line. This type of curve suggests investors may not expect meaningful change in the interest rates..

1. Equity market as of March 31, 2021; Bond market as of September 30, 2020. Source: PIMCO; SIFMA

The Role of Bonds in a Diversified Portfolio

Bonds can play an important role in diversifying a portfolio. Three key potential reasons to consider bonds:

DEFENSE AGAINST CAPITAL LOSS

Barring default, the principal value of a bond is expected to be returned to the investor at maturity. This can make bonds attractive to risk-averse investors who are concerned about losing capital.

INCOME

Bonds can provide investors with a source of income in the form of coupon payments. Often coupon rates are set, so investors can receive this income during different market conditions.

DIVERSIFICATION

Bonds may help diversify a portfolio of riskier assets like equities and this is generally due to the low to negative correlation of bonds with other asset classes.

WHAT IS DURATION?

Duration risk reveals how sensitive a bond is to interest rate movements. In general, the higher the duration, the more the bond value will fall if interest rates rise. Duration (measured in years) estimates the % change in a bond's price for a 1% change in yield.

HOW A 1% RISE IN INTEREST RATES CAN IMPACT BONDS WITH DIFFERENT DURATIONS

1-YEAR DURATION BOND	2-YEAR DURATION BOND	3-YEAR DURATION BOND
-1%	-2%	-3%

Hypothetical example for illustrative purposes only

Key Terms to Know

Asset-Allocation: How an investor distributes their money between different types of investments, such as stocks, bonds and cash. Asset allocation can help balance a portfolio's risk and return (a strategy known as diversification).

Coupon: A coupon is the annual interest payment that the bondholder receives from the bond from its issue date until it matures. Coupons are normally described as the “coupon rate,” which is calculated by adding the sum of coupons paid per year and dividing it by the bond's face value.

Equities: Ownership or proprietary rights and interests in a company.

Fixed Income: Securities/Investments in which the income during ownership is fixed or constant. Generally refers to any type of bond investment.

Maturity: The date on which a loan, bond, mortgage or other debt security becomes due and is to be paid off.

Spread: The risk premium that investors demand, over a base government bond yield, to compensate for the risk taken. Investors should understand that higher-yielding bonds often have considerably higher risk.

Yield: The annual net profit that an investor earns on an investment. Setting aside time and interest rates, a bond yield equals the bond's coupon. Money today is often not worth the same as in the future, though, so yields tend to be higher for longer-maturity bonds.

Interested in learning more? Speak with your financial professional or visit pimco.com

All investments contain risk and may lose value.There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

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