Chapter 11: Financial Markets
Section 2

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ECONOMICS

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Objectives

1. **Describe** the characteristics of bonds as financial assets.
2. **Identify** different types of bonds.
3. **Describe** the characteristics of other types of financial assets.
4. **List** four different types of financial asset markets.

Key Terms

- **coupon rate:** the interest rate that a bond issuer will pay to the bondholder
- **maturity**: the time at which payment to a bondholder is due
- **par value**: a bond’s stated value, to be paid to the bondholder at maturity
- **yield**: the annual rate of return on a bond if the bond is held to maturity
- **savings bond**: a low-denomination bond issued by the United States government

Key Terms, cont.

- **inflation-indexed bond**: a bond that protects the investor against inflation by its linkage to an index of inflation
- **municipal bond**: a bond issued by a state or local government or a municipality to finance a public project
- **corporate bond:** a bond issued by a corporation to help raise money for an expansion
- **junk bond:** a bond with high risk and potentially high yield

Key Terms, cont.

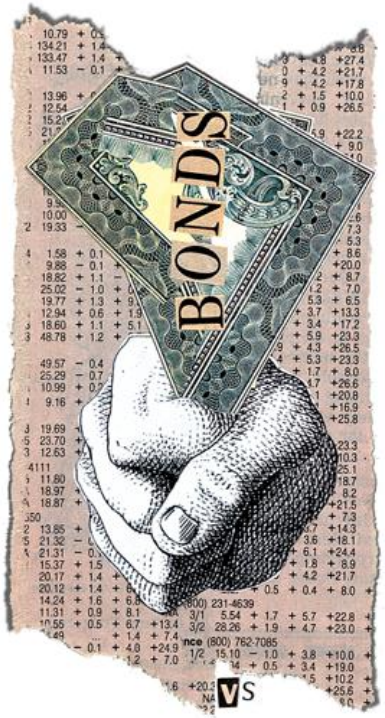
- **capital market**: a market in which money is lent for periods longer than a year
- **money market**: a market in which money is lent for periods of one year or less
- **primary market**: a market for selling financial assets that can be redeemed only by the original holder
- **secondary market**: a market for reselling financial assets

Introduction

- Why are bonds bought and sold?
  - Bonds are sold by governments and or corporations to finance projects.
  - Bonds offer a higher return than savings accounts, although they are generally riskier than savings accounts.

Bonds as Financial Assets

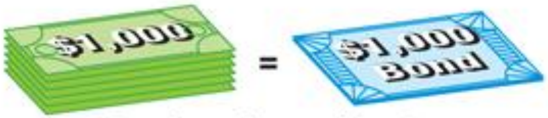
- Bonds are loans that represent debt that the seller must repay to the investor.
- Bonds have three basic components:
  - Coupon rate - the interest rate that a bond issuer will pay to a bondholder
  - Maturity - the time at which payment to a bondholder is due
  - Par value - the amount to be paid to the bondholder at maturity



Discounts From Par

- Investors can not only earn money from the interest on their bonds but they can also earn money by buying bonds at a discount, called a discount from par.
  - According to the chart, how do interest rates affect bond prices?

1. Sharon buys a bond with a par value of $1,000 at 5 percent interest.



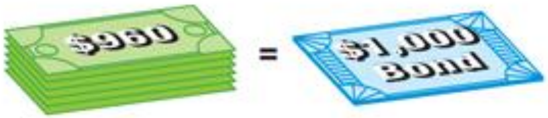
Bond purchase without discount from par

2. Interest rates go up to 6 percent.

3. Sharon needs to sell her bond. Nate wants to buy it, but is unwilling to buy a bond at 5 percent interest when the current rate is 6 percent.

4. Sharon offers to discount the bond, taking $40 off the price and selling it for $960.

5. Nate accepts the offer. He now owns a $1,000 bond paying 5 percent interest, which he purchased at a discount from par.



Bond purchase with discount from par

Bond Ratings

- In order to decide which bonds to buy, investors can check bond quality through independent firms, such as Standard & Poor's and Moody's, which publish bond issuers' credit ratings.
  - These firms rate bonds on the issuer's financial strength, its ability to make future interest payments, and its ability to repay the principal when the bond matures.
  - A high grade, such as AAA, means that the bond is safe to invest in.

Advantages and Disadvantages

- Advantages
  - Once a bond is sold, the coupon rate remains the same.
  - The company does not have to share profits with bondholders if it is doing well.
- Disadvantages
  - The company must make fixed interest payments and cannot change its interest payments.
  - A firm's bonds may be given a low bond rating and be harder to sell when the firm is not doing well.

Types of Bonds

- Savings Bonds
  - Low-denomination bonds issued by the U.S. government, who pays interest on the bonds.
- Treasury Bonds, Bills, and Notes
  - The U.S. Treasury Department issue Treasury bonds, bills, and notes, which are among the safest investments in terms of default risk.

	Treasury Bond	Treasury Note	Treasury Bill
Term	long-term	intermediate-term	short-term
Maturity	30 years	2, 5, or 10 years	4, 13, 26, or 52 weeks
Liquidity and safety	safe	safe	liquid and safe
Minimum purchase	$100	$100	$100
Denomination	$100	$100	$100

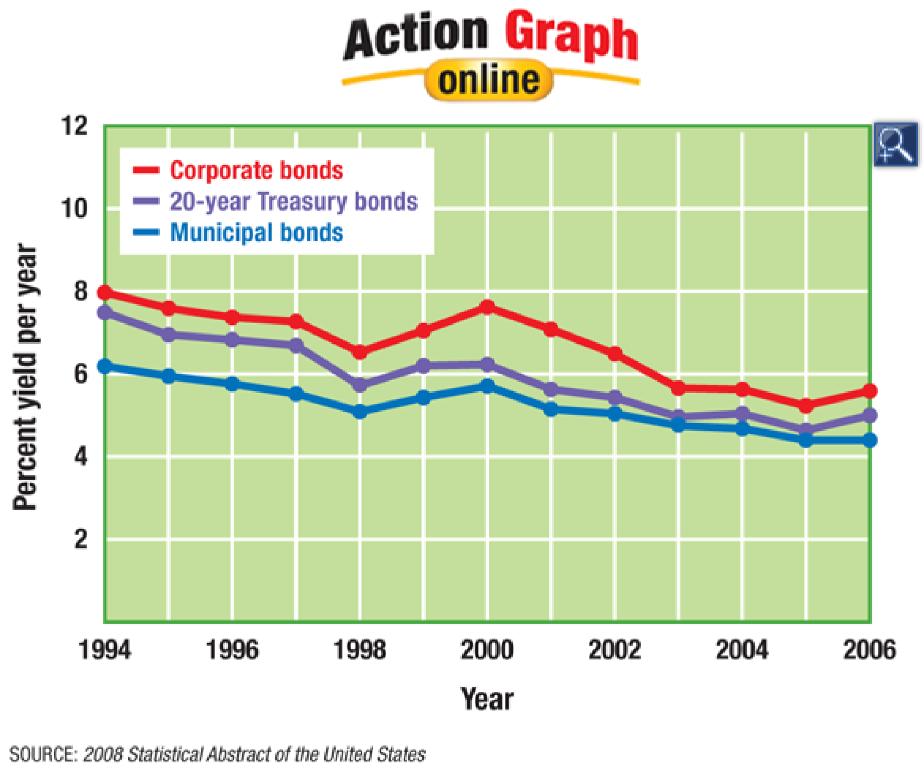
Which of these three types of government securities is the most liquid?

Municipal Bonds

- State and local governments issue municipal bonds to finance such projects as highways, libraries, parks, and schools.
- These are attractive to long-term investments and are relatively safe.
  - Checkpoint: What type of bond might have been used to fund the construction of your school?

Corporate and Junk Bonds

- Corporate bonds are issued by corporation to help raise money to expand business.
  - These bonds have a moderate risk level because investors must depend on the corporation's success.
- Junk bonds are bonds with a high risk and a potentially high return.
  - Investors in junk bonds face a strong possibility that some of the issuing firms will default on their debt.



Other Types of Financial Assets

- Certificates of Deposit
  – CDs are available through banks, which lend out funds deposited in CDs for a fixed amount of time.
- Money Market Mutual Funds
  – Investors receive higher interest on a money market mutual fund than they would on a savings account. These funds, however, are not covered by FDIC insurance.

Financial Asset Markets

- Bonds, CDs, and money market mutual funds are traded on financial asset markets.
- One way to classify financial asset markets is according to the length of time for which the funds are lent.
  - Capital Markets
    - In these markets, money is lent for periods longer than a year, like in a CD.
  - Money Markets
    - In these markets, money is lent for periods of a year or less and include Treasury bills and money market mutual funds.

Financial Asset Market, cont.

- Markets may also be classified according to whether or not assets can be resold to other buyers.
  - Primary Markets
    - In a primary market, financial assets can be redeemed only by the original holder. Examples include savings bonds and small CDs.
  - Secondary Markets
    - In a secondary market, financial assets can be resold, which provides liquidity to investors.
  - Checkpoint: What are two ways of classifying financial asset markets?

Review

- Now that you have learned why bonds are bought and sold, go back and answer the Chapter Essential Question.
  - How do your saving and investment choices affect your future?