Once you’re familiar with the basics of bonds — bond values, yields and types — you’re ready to move on to the three Rs of bonds: risk, rates, and returns. These concepts are important to understand in order to be a well-informed fixed income investor.
RISK

Bonds are investments. And like nearly every type of investment, they carry risks. The good news is that, as an asset class, bonds are widely perceived to be less risky than equities, real estate and alternative investments.

That said, individual bonds can run the gamut from low- to high risk. Always consider the specific risks of any particular fixed-income vehicle or issue, and discuss it with your financial advisor before making a buying decision.

Risks to consider

**Interest rate risk**
This is by far the most important type of risk to fixed income investors, because it impacts nearly every type of bond. Changes in interest rates have a clear impact on the value of bonds and their yields. When interest rates fall, the price of bonds increases, and yields fall. That’s good for bondholders, but bad for bond buyers. However, when the interest rates rise, the opposite holds true: the value of bonds declines, and yields rise, hurting bondholders, but benefiting buyers.

**Prepayment risk**
Certain bonds have provisions allowing them to be “called” before maturity. When this happens, the principal is repaid in full, but the investor is deprived of expected interest income. In addition, some mortgage-backed securities allow for early redemption if too many of the underlying mortgages are repaid early (for example, if mortgage interest rates were to decline dramatically).

**Default risk**
All bonds carry some risk that the issuer will default on interest payments, repayment of principal, or both. In the case of high-quality (investment-grade) bonds, U.S. Treasury securities and bonds issued by developed countries, default risk is relatively low. However, default risk is an important factor to consider with high-yield bonds and those issued by developing countries.

**Credit risk**
This refers to the chance that the issuer’s credit rating is lowered before its bond reaches maturity, making that bond less attractive to investors.

**Currency risk**
When a foreign bond is denominated in a currency other than U.S. dollars, its value will vary depending on the exchange rate between currencies. There’s always a risk that the dollar’s value will decline relative to the bond’s foreign currency, reducing the bond’s value.

**Liquidity risk**
The risk that a bond cannot be sold quickly applies to all areas of fixed income. For example, the market for U.S. Treasury securities is among the most liquid in the world. Other fixed income asset classes, such as high-quality corporate and government-issued bonds, are reasonably liquid under most economic conditions. But low-quality bonds may be difficult to sell at any time, given their high level of risk.
Rates and duration

Interest rates change all the time. And every time they do, bonds are affected. Of course, no one knows when or how much interest rates may change in the future. But it stands to reason that the longer the time remaining before a bond’s maturity date, the greater the possibility that interest rates could change in the interim.

To assess this risk, investors should consider a bond’s duration. Duration is not the time left before a bond matures. Rather, it’s a calculation of the weighted average maturity of a bond’s cash flows.

What you really need to know is this: the longer the duration, the greater the potential for changes in interest rates to affect the bond’s value.

Credit ratings

To help investors accurately gauge the ability of a bond issuer to meet its future debt obligations, several independent firms provide credit ratings based on the issuer’s financial health and history. Two of the most widely used services are Moody’s and Standard & Poor’s. These firms conduct research and assign letter-based ratings to the bonds being offered, as shown in the chart to the right. While these ratings do not constitute any guarantee against default, they are used widely and are important resources to help guide investors.

In general, bond ratings fall into two categories:

Investment grade (high quality) and below investment grade, also known as “high yield” (lower quality). The lower the rating, the higher the perceived potential for default and the higher the yield that investors will demand before purchasing the bond. Investors should keep the following in mind when using credit ratings:

• Ratings are awarded to bonds, not issuers. The same enterprise may issue bonds with different risk levels, with different credit ratings for each.

• Ratings may be periodically downgraded or upgraded based on changes in the issuer’s financial situation.

• Though the rating firms use the same types of letter ratings for both corporate and municipal bonds, these ratings letters only reflect relative risk within each group. An AA corporate bond and AA municipal bond may have the same letter rating, but this does not mean their issuers are equally creditworthy.

Credit ratings at a glance

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The all-important concept of yield

Plan your diversified investing strategy

Legg Mason can help ensure that your portfolio has an appropriate mix of fixed income and other investments, giving you a balance of strategies that can address your need for portfolio growth, income, capital appreciation and risk management. Talk to your financial advisor today about the right investing strategy for your situation.

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What should I know before investing?
Past performance is no guarantee of future results. Diversification does not guarantee a profit or protect from loss; its main value is to help reduce potential volatility within a portfolio.

All fixed income investments are subject to interest rate, credit and inflation risk. Investments in high-yield securities and in foreign companies and governments, including emerging markets, involve risks beyond those inherent solely in higher-rated and domestic investments. The risks of high-yield securities include, but are not limited to, price volatility and possibility of default in the timely payment of interest and principal. Foreign securities are subject to certain risks of overseas investing, including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations. These risks are magnified in emerging markets. Convertible securities are subject to stock market, credit and interest rate risks. Mortgage-backed securities involve additional risk over more traditional fixed income investments, including: interest rate risk, prepayment risk, implied call and extension risks, and the possibility of premature return of principal due to mortgage prepayment, which can reduce expected yield and lead to price volatility.

U.S. Treasuries are direct debt obligations issued and backed by the “full faith and credit” of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.