[MUSIC PLAYING]

Hi this is Dr. Bob Nolley with our next lesson on bonds. We've talked a lot about the terms and the features of bonds, but now is the time to talk about the why. What are some of the advantages and disadvantages of bonds?

Recall that the bond is an instrument of debt, with the issuer being the borrower and the holder being the lender. One advantage that bonds have over stocks is that they have relatively low volatility in terms of price. This means that the shift in price changes for bonds is usually smaller than that for stocks.

Because of this, they seem to be a safer, more conservative investment. And because there is some relative certainty that the fixed interest payment twice a year will happen along with the fixed interest payment at maturity, bonds can be very attractive.

This attraction is also related to the fact that there is an element of legal protection that is present with bonds. If the bond issuer goes bankrupt, bond holders usually receive some money back during the recovery process. The company's stockholders end up with nothing. The bond indenture outlines these terms.

The third advantage is that bonds are usually very liquid. It's easy for a financial institution that has invested heavily in bonds to sell a substantial quantity of them without moving the price. That's much more difficult to do with stocks.

Finally, because finance is an area in which new products are created to fulfill almost every need, there is usually a type of bond available to meet the different needs of investors, including zero coupon bonds, convertible bonds, and floating rate bonds.

There are also disadvantages to bonds. Bonds are subject to various types of risk. One type of this risk is interest rate risk. Bonds that have fixed coupon rates-- and this is most of them-- are subject to interest rate risk. Since the coupon payments are fixed, when market rates rise, the price of the bond will fall. This tells us that investors would be able to get higher interest rates on their money somewhere else in the market.

Maybe they'll invest in newly issued bonds that reflect the higher interest rate. But bonds are also subject to repayment risk. This is for bonds that are callable. And there's the risk that a bond holder's specific bond will be called for early repayment by the issuer.

There is also credit rating risk on the part of the issuer. If a credit rating agency downgrades its rating of the issuer, the market price of the bond will fall. And just as we saw with interest rate risk, it doesn't affect the interest payments, but it does affect the price. This would affect the holders of these bonds who may be seeking to sell them.

Now let's review the advantages and disadvantages of bonds. Advantages include the relative lower volatility of bond prices when compared to stocks. This means price changes in smaller amounts because they're seen as less risky and more conservative.

There's also the legal protection for bond holders through the indenture. If the issuer declares bankruptcy, the bond holder would receive some payment on the bonds they hold, whereas common stockholders get nothing.

Bonds are also very liquid. And this is important because it ensures that bond holders can trade large quantities of bonds without significantly impacting prices.

The disadvantages include several types of risk that can impact bond holders. Interest rate risk stems from the fact that coupon payments do not change when overall market interest rates increase.

There is also repayment risk for bonds that are callable. A bond holder may be unwilling to surrender a bond in their portfolio if it is attractively priced at the time it is called.

And there is also credit rating risk. If a credit rating agency changes the credit rating for an issuer and lowers it, then the price for the bond will fall in the market.

This is Dr. Bob Nolley. And I'll see you in the next lesson.

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