

Chapter 9

Bonds and Mutual Funds

Ken Long
New River Community College
Dublin, VA 24084
<http://www.nr.cc.va/fin107>

**How much would I have
if I saved \$200 a month
for 40 years at 10%?**

\$1,264,873

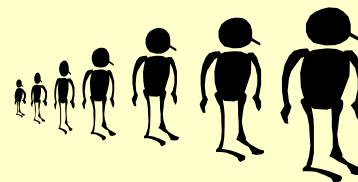
**What would my
monthly income be
at a 4% return?**

\$4,216

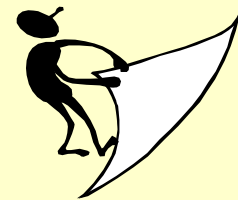


What are the advantages of social security?

- Indexed to inflation
- Forced savings



What are the disadvantages of the social security system?



- The return on savings is much lower than on personal savings
- You have no control over your money
- The principle cannot be inherited
- There can be rule changes
- The system's future is uncertain

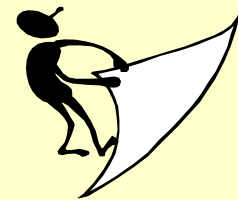
What is an opportunity cost?

That which is given up in the
best alternative endeavor

What is an example of opportunity cost?

If a savings account earns 3% interest, but you could have made 10% in the stock market, your opportunity cost is 7%

What are different ways that taxes effect savings?



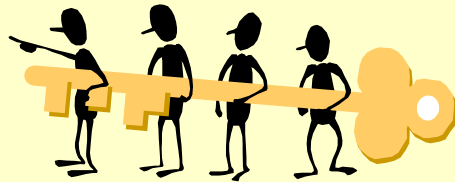
- Taxes are not paid on initial income and are deferred on income from investment
- Taxes are paid on income but are deferred on return
- Taxes are paid on initial income as well as on income from investment

What is a bond?

A certificate of debt issued by a government or corporation guaranteeing payment of the original investment plus interest by a specified date

What are the two types of U. S. Savings Bonds?

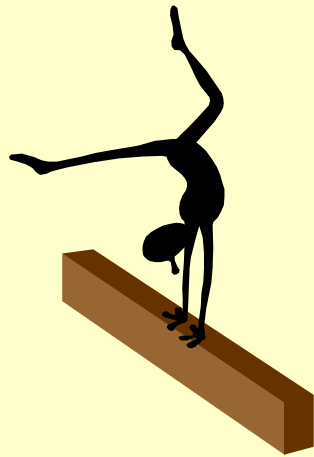
- Series EE
- Series HH



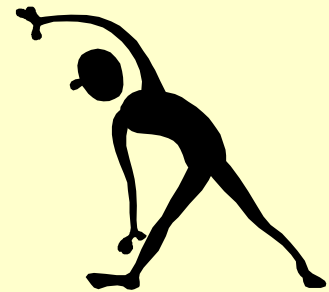
How much will I pay for a Series EE Savings Bond?

Series EE Savings Bond
is bought at 50% of its
face value

How much is a Series EE Savings Bond worth at maturity?



Its face value



How can I compare the interest rate and maturity?

The higher the interest rate, the shorter the time to mature

How do Series HH Savings Bonds work?

They are purchased at face value and pay interest every 6 months

How much do I get back at maturity with a Series HH Savings Bonds?

What you put in



How can I purchase Series HH Savings Bonds?

Only with EE bonds held for more than a month

What is the rule of 72?

The return on an investment divided into 72 will tell you how long it will take the investment to double in value

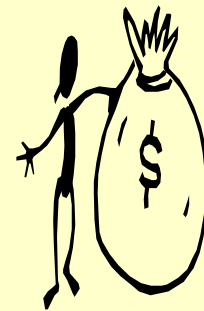
Give an example of the rule of 72?

72 divided by a return of 10% equals 7.2 years



When is the best time to buy savings bonds?

Bonds bought late in the month you will earn interest for the whole month

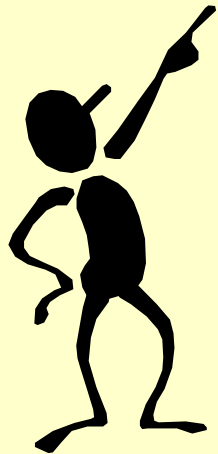


When is the best time to redeem savings bonds?

If you redeem it at the beginning of the month you will earn interest as if you held it for the entire month

What is the maximum I can invest in savings bonds?

\$15,000 a year

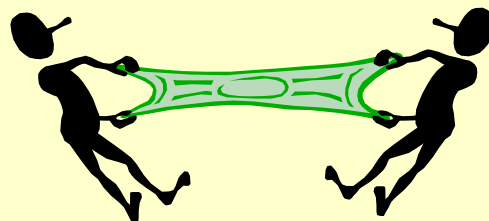


Is the return on a savings bond fixed?

Yes, unless it is held to maturity at which time it is worth the fixed rate or 85% of what a five year Treasury note is paying at the time

How long do I have to keep a U.S. savings bond?

At least 6 months to earn any interest

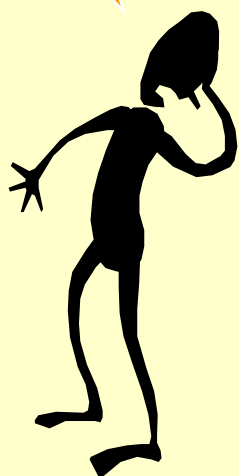


Can I cash in the bond at any time?

Redeeming the bond before maturity will earn you the guaranteed interest up to the time of redemption

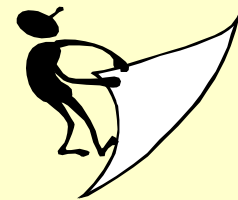
**Do I have to redeem
a savings bond after
it matures?**

No!



You can keep the bond
and continue earning
interest until the bond
is 30 years old

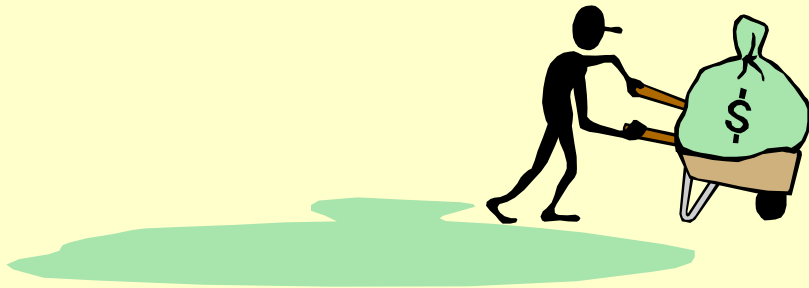
What are some advantages of U.S. Savings Bonds?



- Proceeds used for education is tax free
- Bonds can be bought in small denominations at same rate
- With HH bonds taxes are paid only as you receive the money
- You can postpone taxes after redemption by buying HH bonds
- Federal taxes not paid until bond is redeemed
- No state or local taxes on return
- You can purchase and redeem at banks
- Automatic withdrawal from paycheck
- No commissions or fees

What is a U.S. Treasury Security?

A U.S. government bond



Are taxes paid on Treasury Securities?

State and local taxes are
not paid, but federal
taxes **are** paid



What is a secondary market?

A market that a bond can be bought and sold after the initial purchase but before its maturity

**What is a
another name for
secondary market?**

Bond Market

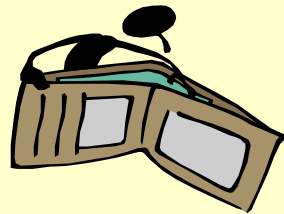


What determines the price of a bond in the secondary market?

What the buyer and seller agree upon

Why do longer term bonds pay a higher interest?

Greater risk and more time
to use purchaser's money



Why do bond prices rise when interest rates fall?

Sellers of bonds are in a better bargaining position

Why do bond prices fall when interest rates rise?

Buyers of bonds are in a
better bargaining position

What are the types of marketable securities?



- Bills
- Notes
- Bonds

What is a treasury bill?

Short-term obligations
issued with a term of
13 weeks, 26 weeks, or
52 weeks

What is par?

The date a bill matures



When does the purchaser of a bill receive payment?

The bill only pays interest when it matures

What is a treasury note?

A medium-term obligation
issued with a term of at
least one year but no
more than ten years



When are interest payments made on treasury notes?

Semi-annually

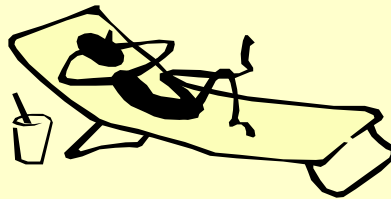


What is a treasury bond?

A long-term obligation
issued with a term
greater than ten years

When are interest payments made on treasury bonds?

Semi-annually



Treasury securities can be purchased from ...

- security dealers
- banks
- brokers
- Federal Reserve Banks
- Bureau of the Public Debt

What are advantages of buying securities directly from the government?

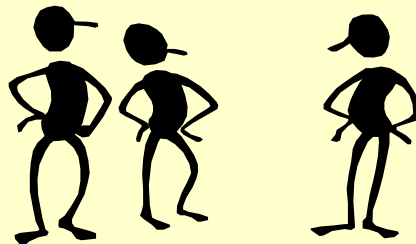
- Several options
- You will not have to pay a fee or commission
- The Security will be in your name

**When I buy a security
from a bank will it be
in my name?**

Usually the Security will
be in the name of the
bank or brokerage house -
called the “street name”

**Why does a bank or
brokerage house want
the security in its name?**

Less time and paper work



Am I taking a risk with a street name?

If the seller goes out of business you will have to deal with Securities Investor Protection Corporation to have your money refunded

**Can I buy a security
from a bank or a
brokerage house and
have it in my name?**

YES

**What is another
downside to holding a
security in my name?**

You you will not
be able to sell it

How do I contact the Bureau of the Public Debt?

Bureau of the Public Debt
Division of Customer Services
Washington, DC 20239-0001

How do I contact the Federal Reserve?

(202) 874-4000

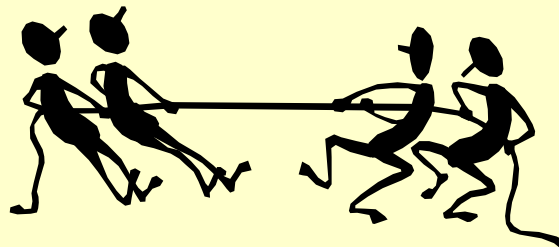
<http://www.frb.ny.org>

What is a zero-coupon bond?

Municipal, corporate, or
U.S. Treasury bonds
issued at prices below
their face value

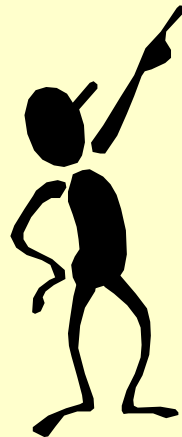
When do zero-coupon bonds pay interest?

They do not pay interest until they mature



**What is the least amount
of money I need to buy a
zero-coupon bond?**

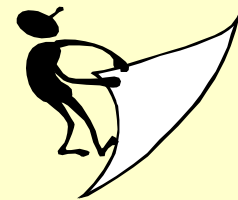
\$250



What is a municipal bond?

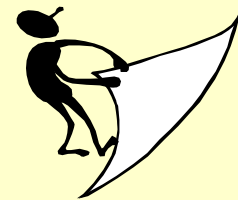
IOU's issued by state and
local governments and by
special purpose
government agencies

What are the advantages of municipal bonds?



- They are guaranteed in case of default
- Municipal bonds are usually not callable for at least 10 years
- No state taxes have to be paid if the municipal is in your home state
- No federal taxes have to be paid on the return

What are the disadvantages with municipal bonds?



- Fees paid are not tax deductible when a capital gain is made
- The interest rate offered is lower, everything else being equal, because of the tax advantage
- Profits are subject to state and local capital gains tax

Who gains the most from municipal bonds?

High income people

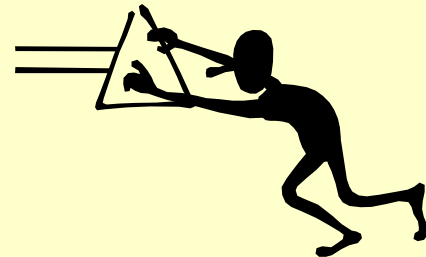


Can municipal bonds be bought directly?

Municipalities prefer to sell bond issues to underwriters who sell them to brokerage houses

How much will I have to pay for a municipal bond?

Usually for a \$1,000 or less



What are the two types of municipal bonds?

- General Obligation
- Revenue

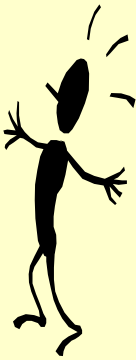


What is a general obligation bond?

The obligation is met by
tax revenues

What is a revenue bond?

Obligation is met by
revenues of specific
projects, like roads,
schools and bridges



Which type of bond is most risky?

Revenue bonds tend to be more risky because the revenues from the projects may not live up to expectations

What is a tax equivalent yield?

The amount of your gain
considering taxes



What is a tax equivalent yield called?

Effective interest rate



What is a stock market?

A place where



people buy and sell
shares of stock

What is a share of stock?

Is ownership in the assets,
earnings, and future
direction of a corporate
form of business

What is the money market?

A place where people
buy and sell securities

What is a mutual fund?

An investment company that combines the funds of investors who have purchased shares of ownership in the company

Where does a mutual fund invest?

The stock, bond
or money market

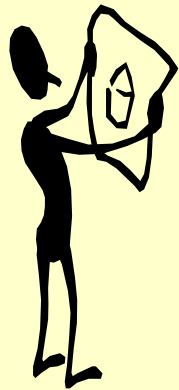


What is a no-load fund?

Has no commissions
and fees when
transactions are made

Do no-load funds have any charges?

All funds have an
expense ratio
called 12b-1 fees



How much should I pay in 12-b1 Fees?

Avoid paying 12b-1
fees of more than a
quarter percent a year

What is a load fund?

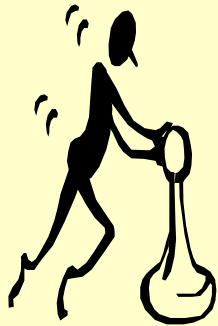
Commissions and fees
are paid when



transactions are made

What are the different kind of loads?

- Front-end
- Back-end



What is a front-end load fund?

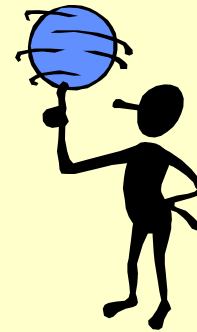
A fund where you pay
commissions and fees at the
time you buy from the fund

What is a back-end load?

You pay a commission
or fee when you sell
from the fund

What can I buy through a mutual fund?

- Stocks
- Bonds
- Money Market



What is the money market?

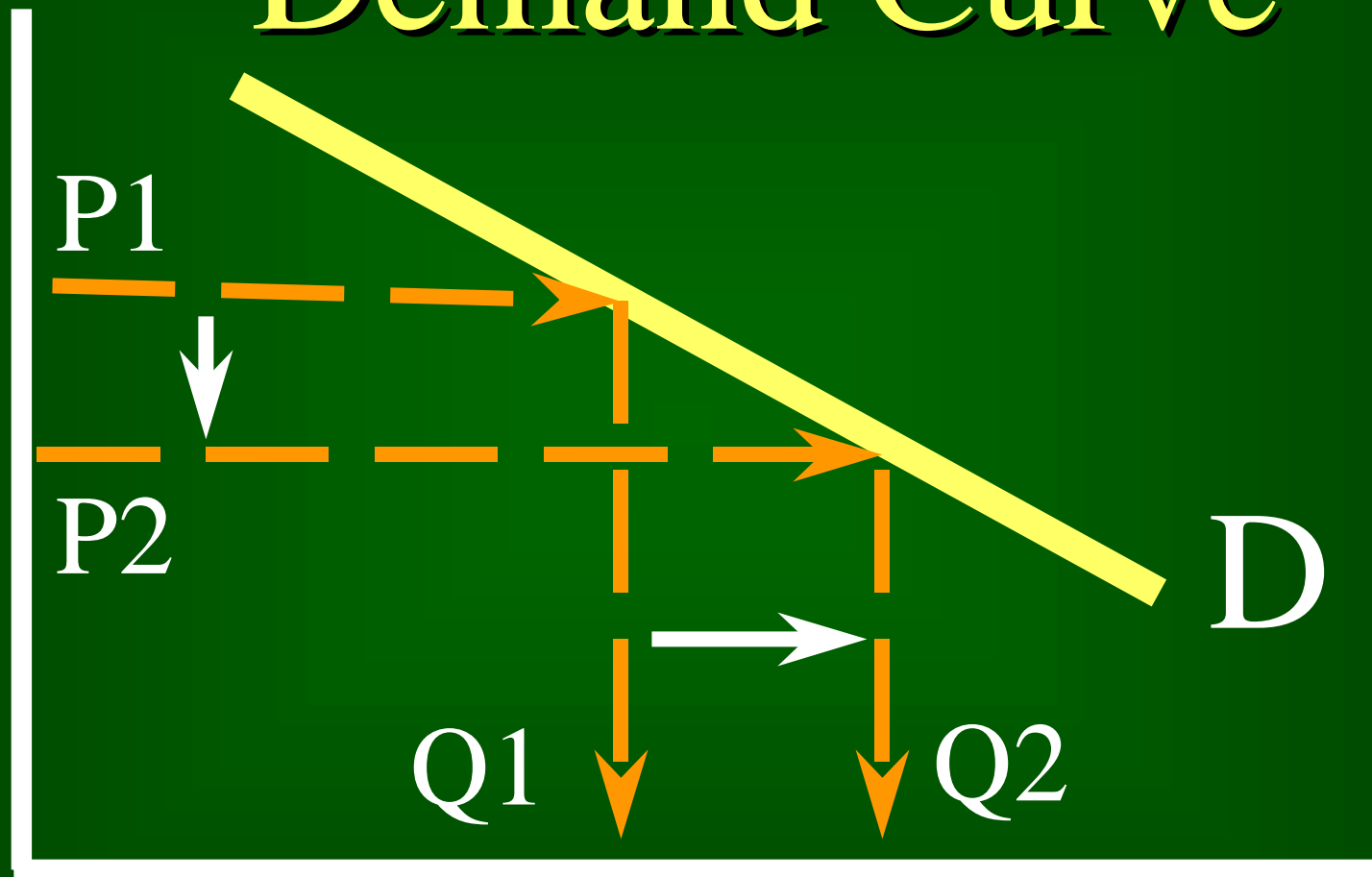
Specializes in purely
interest earning assets

What determines the prices of stocks in the stock market?

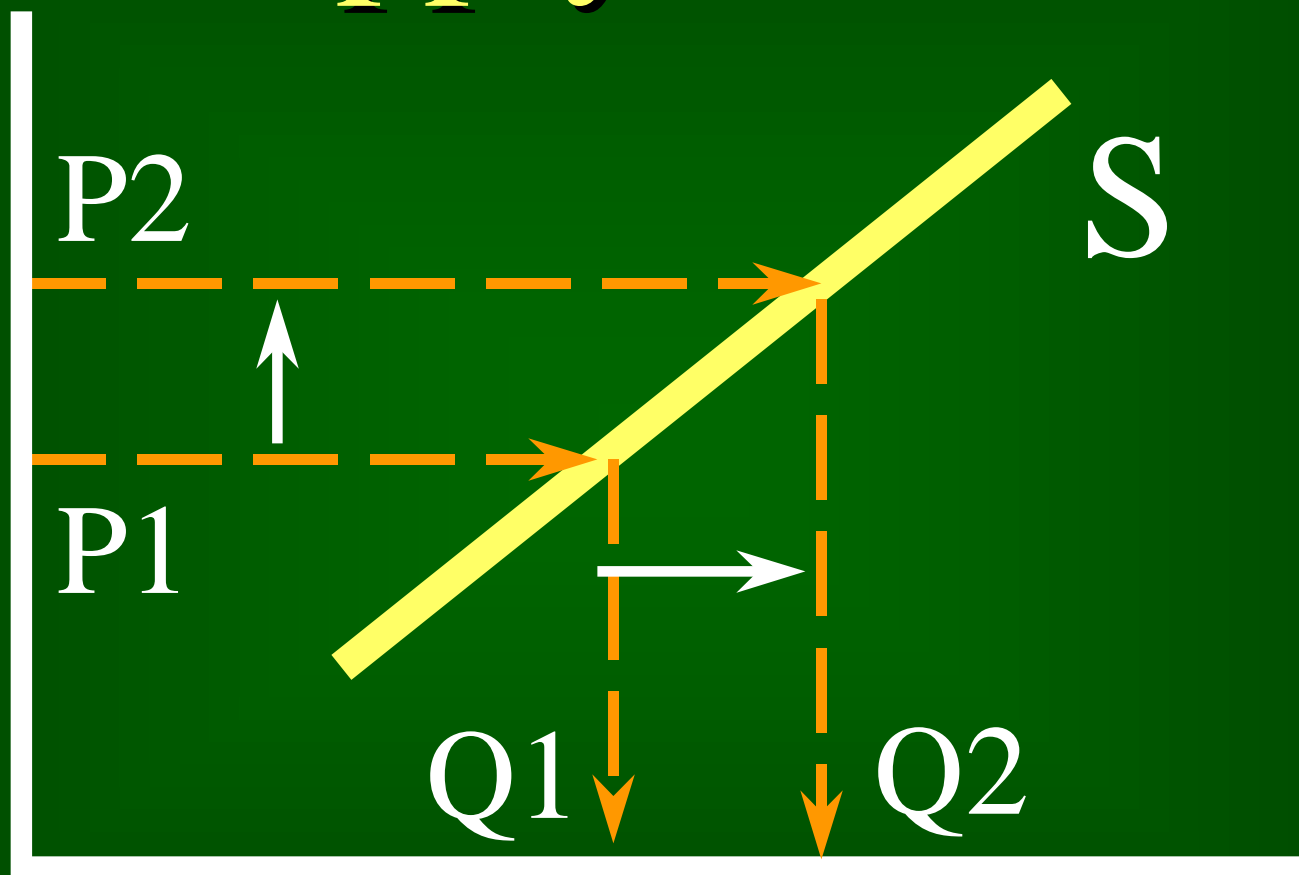


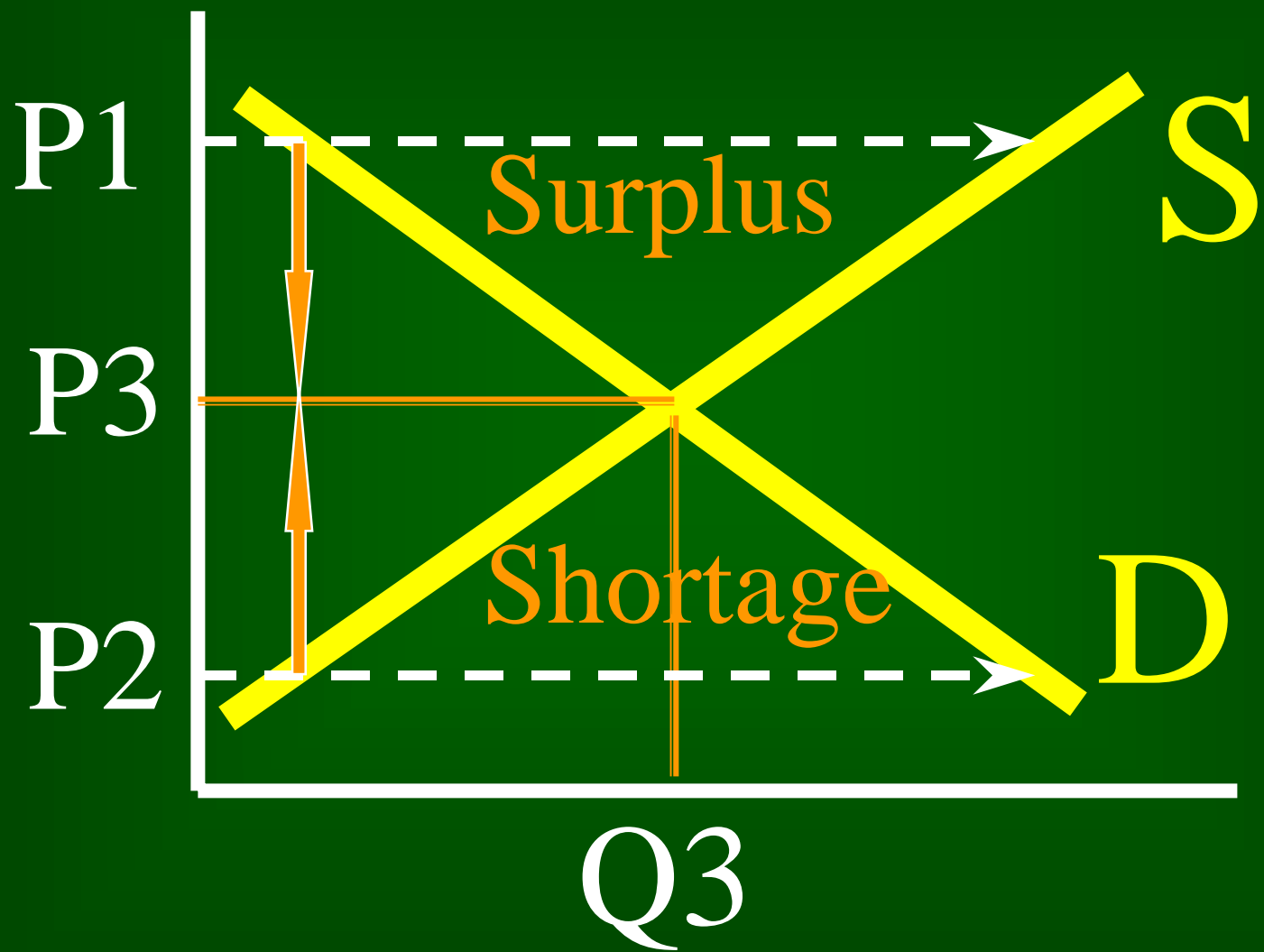
By supply and demand of the particular stock

Demand Curve

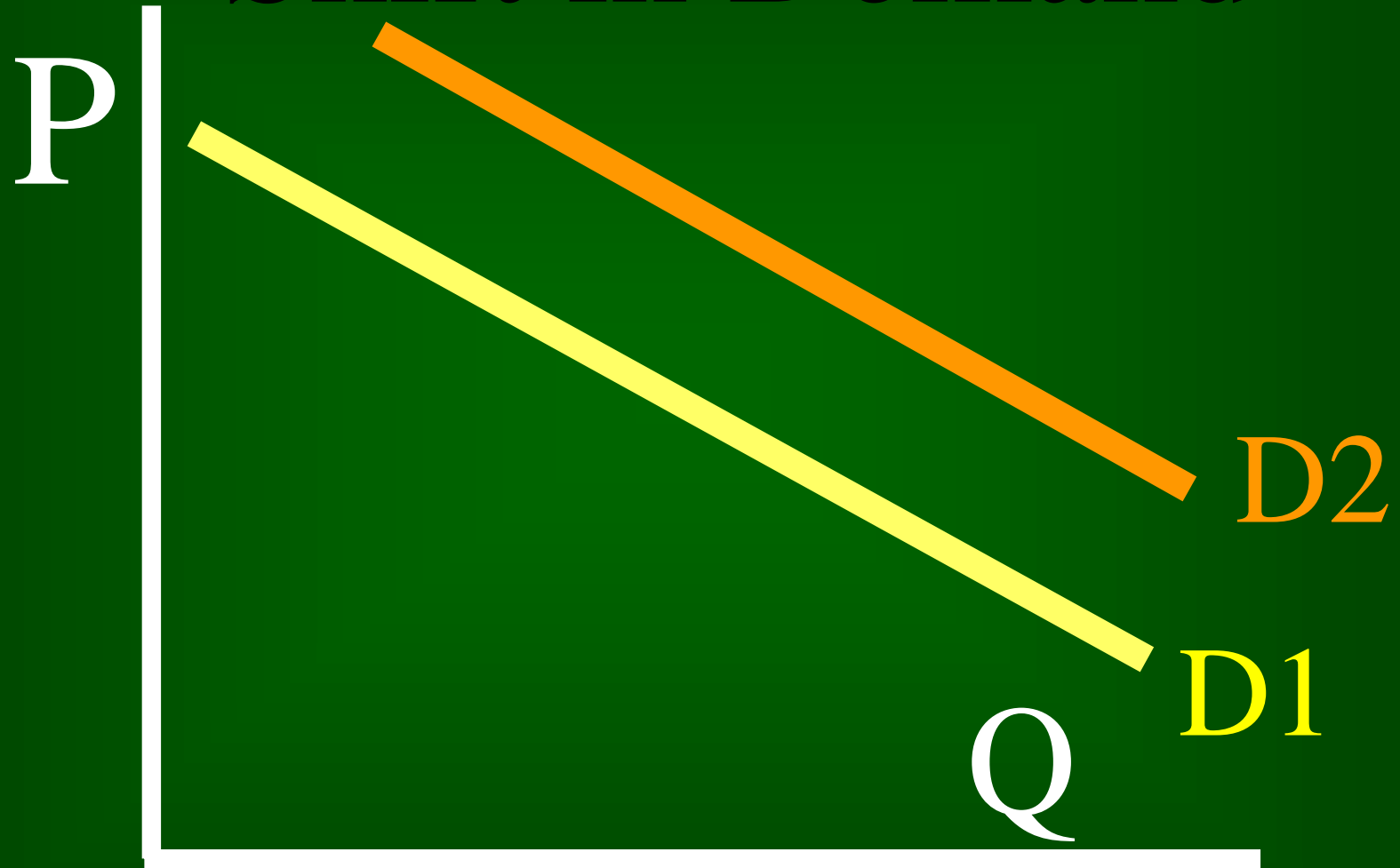


Supply Curve

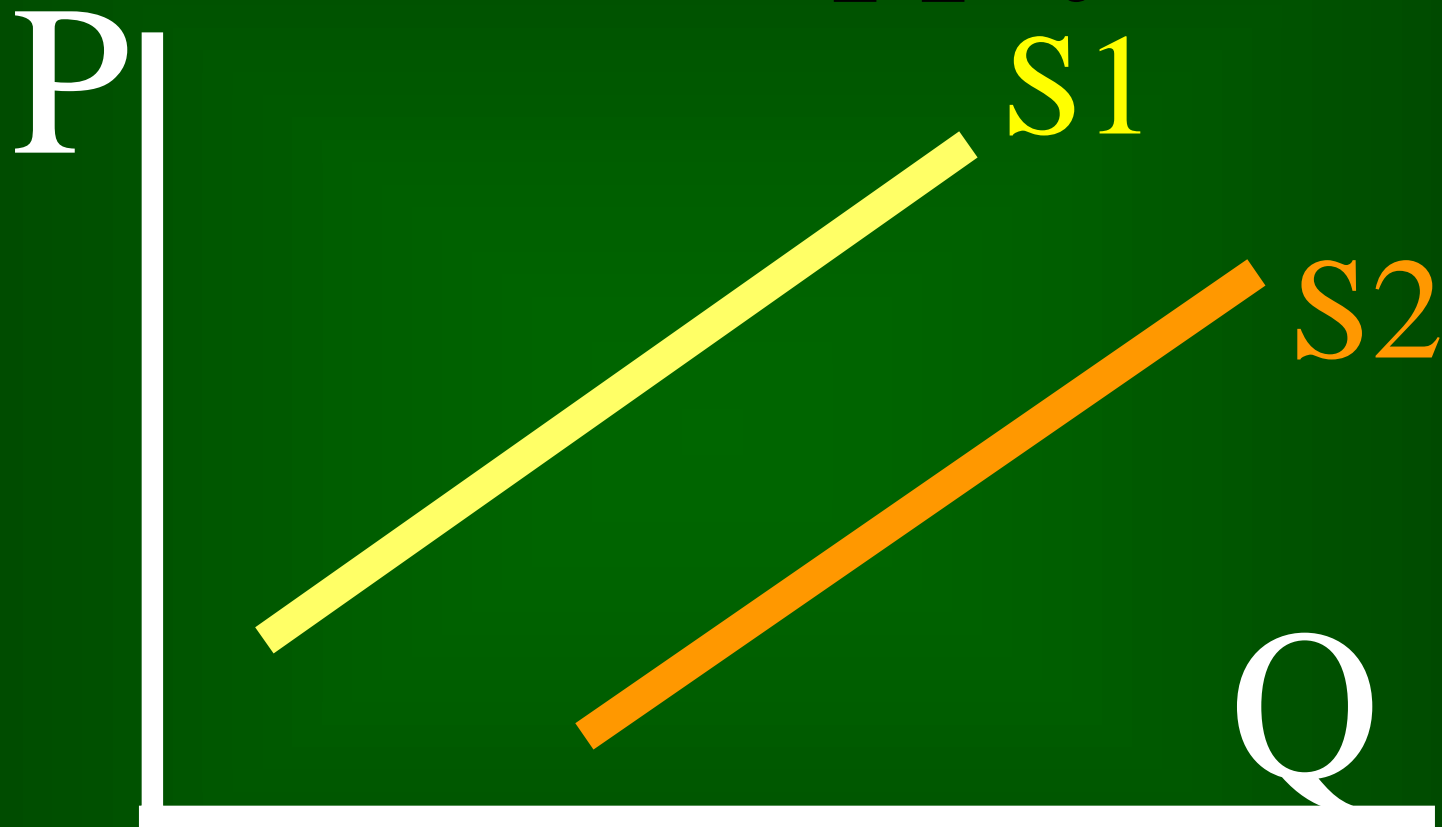




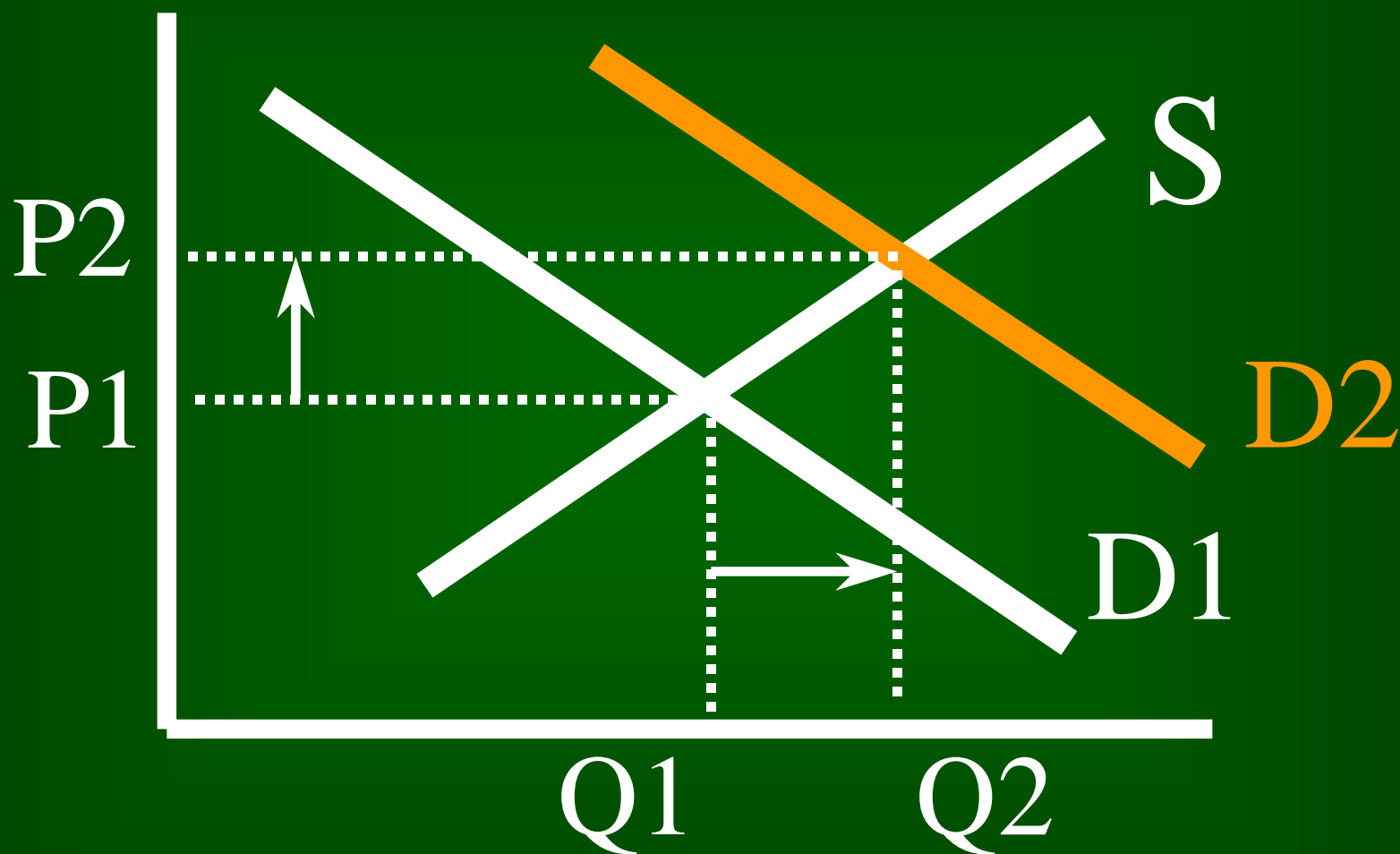
Shift in Demand



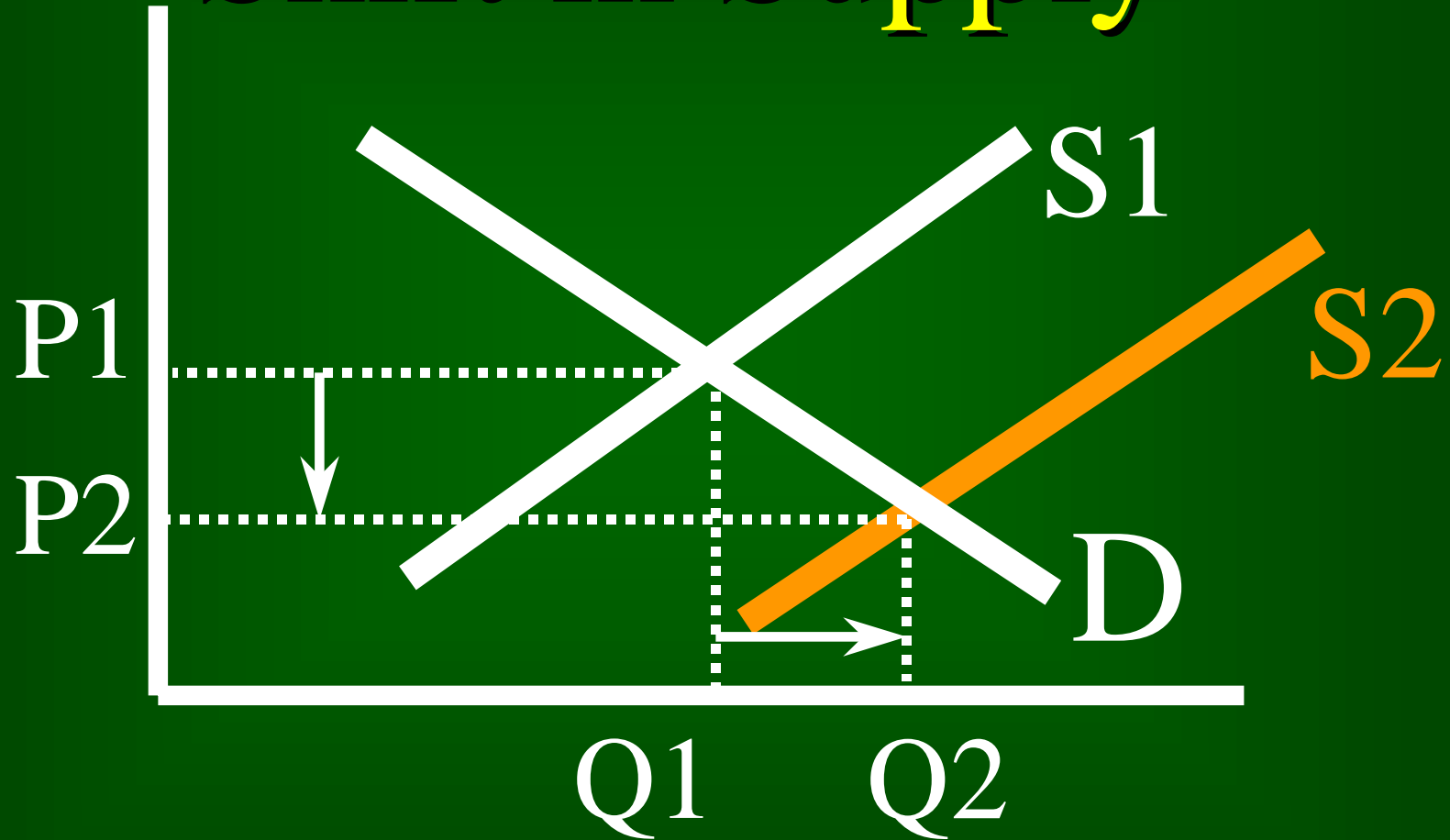
Shift Supply



Shift Demand



Shift in Supply



How do capital gains taxes relate to stocks?

When you sell a stock for more than you paid for it, you owe a capital gains tax

How do income taxes relate to stocks?

When you receive a dividend
from the stock, you owe
income tax on that income

What are three ways to make money in the bond market?

- Interest
- Sell the bond for more than you paid for it
- Reinvest your accrued interest back into the fund

Why am I vulnerable to the market when I buy bonds through a mutual fund?

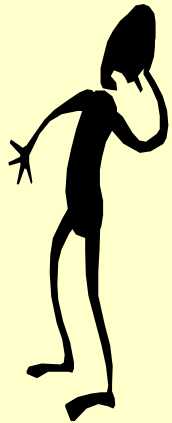
Because mutual funds sell bonds before they mature

What is the effect of a change in interest rates on bonds?

- When interest rates rise by 1 percent, bond prices fall by about 10 percent
- When interest rates fall by 1 percent, bond prices rise by about 10 percent

What if I owned the bond myself?

No!



You have the choice of keeping or selling it when bond prices fall

What is a callable bond?

A bond that the seller can simply pay you off when it is in his favor to do so



Why would a corporation make a call on a bond?

In times of falling interest rates, a corporation can save money by paying off high interest and replacing it with low interest debt

Is there an advantage of owning bonds through a mutual fund?

Yes!



You are less susceptible to a bond call

What is an annual distribution?

Each year mutual funds are required to distribute to shareholders any income that exceeds fund expenses

Do I pay taxes on annual distributions if I keep my money in a fund?

Any income is subject to income taxes and any capital gains is subject to capital gains taxes in the year they are paid

When is the best time to buy into a mutual fund?

Shortly after the fund's distribution



What happens if I buy into a mutual fund just before the distribution?

You can pay taxes on phantom income or capital gains because it represents the profits of others

How can I avoid paying taxes on phantom gains?

- After the first of the new year, take your combined money and buy back into the mutual fund
- Receive your distribution in cash then sell all of your stock before the end of the year

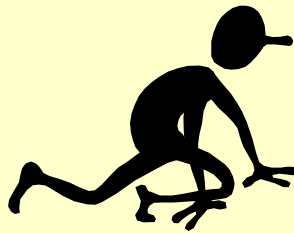
Why will selling and then buying back into the mutual fund save taxes?

Because your gains will be exactly offset by your losses



When do mutual funds pay distributions?

Normally during December



What is IRS Form 1099-DIV?

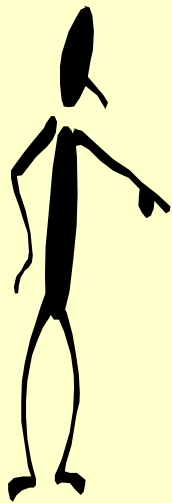
When you receive
distributions you receive
IRS Form 1099-DIV

How do I know when to buy stocks, bonds, or securities?

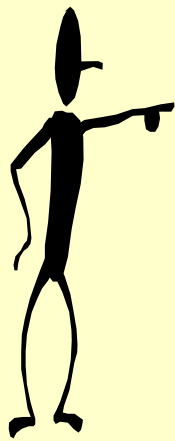
Depending on interest rate movement, there is a best time to buy into one of these three markets

When is the best time to buy into the bond market?

When interest rates
are falling bond
prices are rising



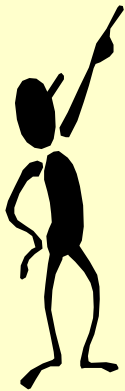
When is the best time to buy into the stock market?



When interest rates
are in a valley

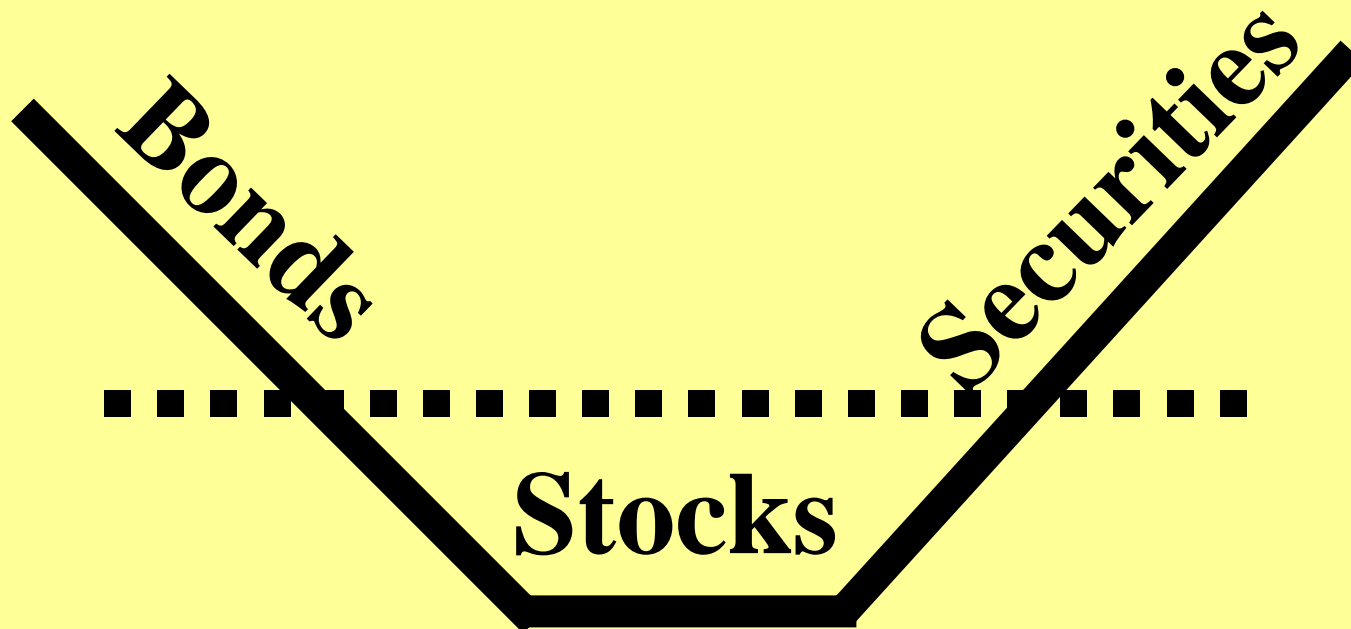
When is the best time to buy into the money market?

When interest rates are above a certain level and are rising



Money Movement Strategy

Prime interest rate



Months

When does the money movement strategy work the best?

Within a tax deferred
no-load mutual fund



How many mutual funds are there?

About 4,000 in U.S.



What are the different kind of funds available?

- Balanced
- Growth
- Income
- Index
- Industry
- International
- Money market
- Municipal

What are some helpful magazines?

- Barron's
- Forbes
- Financial World
- Business Week
- Kiplinger's
- Money
- Fortune
- Morningstar

Can magazines be biased?

Yes!



Especially with
companies who
advertise with them and
authors can be biased

Where might be a better place to get advice?

- Stock broker
- Financial advisor



Is a fund's past performance a good indicator of its future performance?

Not usually, especially if the fund has changed managers

Are some funds more stable than others?

YES, large funds tend to be more stable than smaller funds



**How much will it cost
me to get started in a
mutual fund?**

\$1,000 to \$3,000

Is there a cheaper way?

With automatic withdrawal from your checking account monthly, as little as \$100 could get you started with some funds

END