What?

Bonds are fixed income securities. They are issued to borrow money from investors. Investors usually buy bonds with the intention to hold them until the maturity. It is also possible to speculate with bonds and trade them frequently. There are certain risks inherent to bonds. These are default, market and interest rate risks.

Simple terminology

Issuer: This is the party who is borrowing money through the bond.

Bond holder: This is the party who is lending the money through the bond.

Bond price: This is the current price that bond investor pays to purchase a bond. If it is issued for the first time, this payment is received by the investors. If the issue is already trading in the market, this payment is received by the re-seller (i.e. trader) of the bond.

Maturity date: This is the date at which bond will mature and payment will be due from issuer to the bond holder.

Face value: This is the amount written of the face of the bond. This is the amount the issuer will pay the bond holder on the maturity date.

Coupon: This is the periodic payment that issuer pays to the bond holder. Not every bond pays a coupon. Coupons can be fixed or variable.

Default risk

Default risk refers to the risk of non-payment by the issuer to the bond holder on the maturity date. Default can also take place in case of coupon non-payment.

Investors who hold bonds until maturity bear the default risk.

Investors who speculate with bonds also bear the default risk.

Interest rate risk

Interest rate risk is also referred to as market risk.

Once the bond is issued, it is sold at a price. This price determines the yield. Notice that bond holder will receive a constant face value which does not change through time. So the current price determines the percentage yield bond holder will earn by holding the bond until the maturity.

There are other bonds in the market. Other issuers and other investors. Market and economic conditions change. If interest rates in the economy increase, new borrowers will need to pay higher yields to be able to borrow. In order to pay higher yields, the bond prices will need to decrease.

If we bought our bonds earlier and paid higher prices, this decrease in bond prices will effect us, too.

In other words, our bond's price will go down as market yields go up.

If our intention is to hold our bond until maturity, our market risk is not going to cost us any money. It is more like an opportunity cost. We could have earned more. However, our initial intended earnings will not change. We will just regret that we could have higher earnings.

If our intention is to speculate with bond then we have a problem. The bond that we bought with the expectation of selling it at the higher price at a later date just lost value. So, we sell at a lower price and realize a loss.

Liquidity risk

Liquidity of bond refers to the ease and speed to resale. In other words, once we buy a bond, we should be able to sell it back quickly and with no loss. However, this is not always the case.

Treasuries are considered to be the most liquid of all fixed income securities.

However, note that there is no organized exchange for bond like there is for stocks. Thus, we are ultimately dependent on individuals and institutions providing buy and sell prices, also known as quotations. If there are no quotations available, we may end up waiting to sell our bond. If nobody buys our offer to sell then we may have to wait a while. If nobody still buys our offer we may have to lower our price to be able to sell. This is referred to as liquidity risk.

If our intention is to buy and hold our issue until its maturity then liquidity risk is of no concern to us. However, if our intention is to speculate with bonds than liquidity is a major concern for us.