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A Primer on Bond Prices and Interest Rates | Biz Brain

By Karin Price Mueller | NJMoneyHelp.com for NJ.com
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Q. Can you explain how individual bonds work? When prices go down, what happens to the interest rate? -- Investor

A. Sure thing.

It's helpful to think of yourself as a lender when you invest in individual bonds.

When you buy a bond, you're lending money to the bond's issuer, who promises to pay you interest each year and to return your principal -- par value or face value -- when the loan matures on the maturity date, said George Kiraly, a certified financial planner with LodeStar Advisory Group in Short Hills.

He said the rate at which the issuer pays you is the bond's stated interest rate or coupon rate, which is generally fixed when the bond is first issued.

"The coupon rate simply tells you the amount of interest you will receive over the life of the bond," he said. "For example, a bond with a 5 percent coupon rate and a $1,000 face value will pay the bondholder $50 each year."

Let's go further.

Interest rates and bond prices have an inverse relationship. When one goes up, the other goes down. So, when interest rates rise, bond prices fall.

"That's because when rates climb, new bonds are issued at the higher rate, making existing bonds with lower rates less valuable," Kiraly said. "Interest rates change daily as do the prices of bonds. After bonds are issued, investors can sell them on the secondary market."

He offered this example: If a new investor buys the bond for $900 instead of $1,000 -- its value decreased as market interest rates rose -- on the secondary market, while the coupon rate will still be 5 percent, the yield will be higher both because that investor only had to invest $900 to get $50 a year and because he'll get back $1,000 when the bond matures.

The same thing can happen in reverse, Kiraly said. If interest rates were to fall, that same investor may buy the bond for $1,100 -- above par value -- reducing his yield.

Kiraly said daily price changes don't affect you once you've purchased your bond as long as you don't sell it before its maturity date. Even though the market price of a bond fluctuates, its face value remains the same, providing the company issuing the bond doesn’t default, he said.

It's important to do a risk assessment prior to purchasing a bond, Kiraly said.

"Interest rates have the single largest impact on bond prices, but there are other factors that go into determining the attractiveness of a particular bond:
the creditworthiness of its issuer, whether the issuer can repurchase and retire the bond, the length of time until the bond matures, whether its interest is taxable and so on," he said.

The bottom line? If you own an individual bond and plan to hold it to maturity, then you won't need to be concerned about changes in interest rates, Kiraly said. Because you have no plans to sell your bond, its daily fluctuations are irrelevant to you.

Just remember that if you need to sell your bond on the secondary market before it matures, you may get less than your original investment back.

Email your questions to Ask@NJMoneyHelp.com.

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