Bonds and Other Financial Assets

Chapter 11

Section 2

1. How does an investor earn money by buying bonds at a discount?

The investor buys bonds below par value and earns full par at redemption in addition to the interest.

2. What are Standard & Poor's and Moody's ratings based on?

The issuer's ability to make future interest payments and to repay the principal when the bond matures.

3. What advantages do bonds offer to firms that issue them?

Interest rate is fixed and despite a possible rise in overall interest rates. The firm does not have to share profits with bondholders.

4. What disadvantage do bonds present for the issuer?

Issuer pays set amount of interest even in bad years or if interest rates drop. The bonds of a firm in poor financial health may be downgraded, making them hard to sell unless offered at a discount or high interest rate.

5. What types of government bonds are available to investors? Which type offers the greatest tax advantage?

- Savings bonds
- Treasury bonds, bills, and notes
- Municipal bonds

Municipal Bonds

6. What three organizations help ensure value and prevent dishonesty in the bond market?

- Standard & Poor’s
- Moody’s
- Securities and Exchange Commission

7. What is the investment advantage of money market mutual funds over CDs and savings accounts. What is the disadvantage?

- Higher interest rates (advantage)
- Slightly riskier-not insured by the FDIC (disadvantage)

8. In the financial asset markets, how do capital markets differ from money markets?

- In capital markets, money is lent for periods longer than a year.
- In money markets, for shorter periods. (less than a year)

9. How do primary markets differ from secondary markets?

- Primary assets that can only be redeemed by the original holder are sold on primary markets
- Secondary assets that can be resold are sold on secondary markets

10. Why would investors buy a junk bond?

Junk bonds pay a potentially higher level of interest than other bonds

11. What is the difference between a primary market and a secondary market?

- A primary market is financial assets that can be redeemed only by the original investor
- A secondary market's assets can be resold.

12. How does the risk involved in a money market mutual fund compare with the risk of a certificate of deposit (CD)?

- The risk of the money market mutual fund is slightly greater than that of the CD.

Key Terms

Coupon Rate

- The interest rate that a bond issuer will pay to a bondholder

Maturity

- The time at which payment to a bondholder is due

Par Value

- The amount that an investor pays to purchase a bond and that will be repaid to the investor at maturity

Yield

- The annual rate of return on a bond if the bond were held to maturity.

Savings Bond

- Low-denomination bond issued by the United States government

Municipal Bond

- A bond issued by a state or local government or municipality to finance such improvements as highways state buildings, libraries, parks, and schools

Corporate Bond

- A bond that a corporation issues to raise money to expand its business

Securities and Exchange Commission

- An independent agency of the government that regulates financial markets and investment companies

Junk Bond

- A lower-rated, potentially higher-paying bond

Capital Market

- Market in which money is lent for periods longer than a year

Money Market

- Market in which money is lent for periods of less than a year

Primary Market

- Market for selling financial assets that can only be redeemed by the original holder

Secondary Market

- Market for reselling financial assets