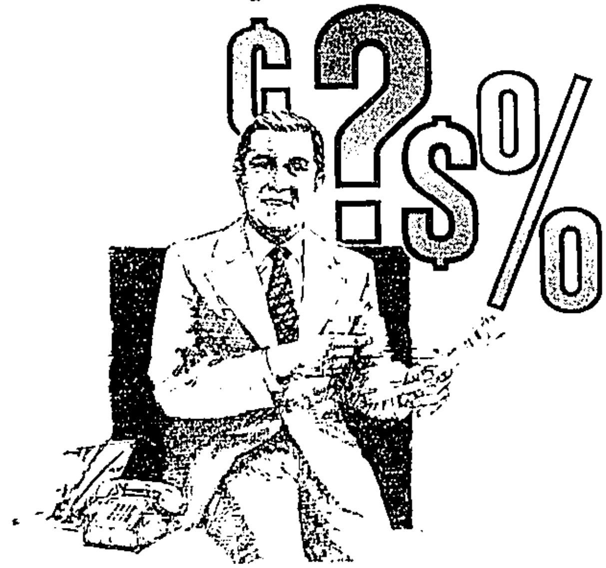
How bonds can affect financial planning



SHOULD YOU invest in corporate bonds or municipal bonds? Before you decide, says the Michigan Association of CPAs, you should understand how this kind of investment will affect your tax and total financial situation.

A bond is an I.O.U. from a corporation or municipality. Bonds are issued to raise capital to build plants, buy machinery and maintain a business. If you lend your money to a corporation by buying its bonds, the corporation promises to pay you back with interest.

Typically bonds are sold in $1,000 units. So, if you buy a $1,000 bond, and it pays a 10 percent annual interest, you receive $100 a year until the bond matures. Interest is usually paid out twice a year. At maturity, you receive the $1,000 original investment — also called the face value.

BONDS PROVIDE a relatively secure return on your investment. However, inflation and changes in interest rates can make your investment less attractive. Here's how: After investing in a $1,000 bond that pays 10 percent interest, the interest rates on other investments may rise. If new bonds are issued at a 15 percent interest rate — $150 a year — your $100 return is no longer as attractive, and the value of your bond decreases if you want to sell it.

Conversely, your bond may become more valuable if interest rates fall below the 10 percent rate of return. The bond you paid $1,000 for will be worth more on this "secondary" market — where bonds are traded — when interest rates decline.

The interplay between interest rates and bond prices is measured by the bond's current yield. To find the current yield, divide a bond's annual interest rate by its current price. For example, take a bond issued at $1,000 and paying 15 percent interest. Say interest rates rise, making the bond's 15 percent rate less attractive and forcing down the price of the bond should you want to sell it.

Then, if the bond's price slips to $950 on the secondary market, you would compute the current yield by dividing the annual $150 interest payment by the current market value of $950. In this case, the current yield would be 15.8 percent. As you can see, when prevailing interest rates rise, the current yields on existing bonds also rise.

THE RATE OF RETURN on a bond is not the only factor to consider when you are looking for the right bond to buy. Bonds are rated by independent financial services, such as Standard and Poor's and Moody's. The rating indicates the bond issuer's capacity to pay investors interest and repay the principal when the bond matures. Generally, the higher rated bonds pay less in interest because the risk of default is lower. You will find that a bond rated AAA offers a yield two or three percentage points lower than those rated BBB, because AAA is less risky.

One type of bond, which has been issued with increasing frequency in recent years, is the municipal bond. These bonds are issued by state and local governments or their agencies, not corporations. Interest on municipal bonds is exempt from state and local income taxes in the areas in which they are issued. Because these bonds are tax-exempt, a municipality can offer an interest rate that is lower than that of a corporate bond.

The lower interest rate may be offset by receiving interest income that is tax-free. Your effective yield depends on your tax bracket. If you are in the 44 percent tax bracket, the yield on a 10 percent tax-exempt investment is equivalent to a taxable yield of 17.86 percent. A rule of thumb is that those in the 40 percent or higher tax bracket should be able to benefit by investing in a municipal bond rather than a corporate bond.

Consult your tax adviser before making this sort of tax-advantaged investment.