



What is a bond?

A bond is like an IOU. You lend a borrower some money, and in return you receive a promise of repayment, plus interest, at a set date. There are many types of bonds with varying degrees of risk, including the following:

- **Corporate bonds** are issued by corporations seeking to raise capital. In general, they offer the highest yield but also have the highest risk.
- **Municipal bonds**, also called "munis," are issued by state or local governments. They are popular among investors in high tax brackets, thanks to the fact that they usually are not subject to federal and state taxes.
- **Government bonds** are issued by the U.S. Treasury or other federal agencies. Treasury bonds (10- to 30-year maturity), Treasury notes (1- to 10-year maturity), and Treasury bills (90-day to 12-month maturity) are backed by the full faith and credit of the U.S. government and considered the safest of debt instruments. While they are free from state taxes, they are subject to federal taxes. Most other bonds issued by federal agencies are not guaranteed by the federal government, but they are still considered high-quality investments.

How bonds are rated

Bonds are rated to help investors understand how risky they are. So before you buy a bond, it's important to understand its rating.

Bonds are rated on their credit quality by major rating systems like Standard & Poor's and Moody's. The ratings are based on the likelihood that the bond issuer will default, failing to pay its obligation to investors.

Here's the basic rating system:

- AAA by Standard & Poor's (Aaa by Moody's)—highest-quality bonds
- BBB or higher by S&P (Baa or higher by Moody's)—investment-grade bonds, for consideration by prudent investors
- Below this threshold—riskier but higher yielding bonds, often referred to as "junk bonds"
- DDD or lower by S&P—bonds already in default

Not surprisingly, lower-quality bonds generally offer higher returns as an incentive to purchase in spite of the higher risk.

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