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## **Bonds and Bond Mutual Funds: What's the Difference?**

*A bond is basically a loan from you, the bond owner, to the bond issuer, which could be a corporation, government, government agency or municipality.*

Normally, the bond issuer pledges to make regular interest payments and to repay the bond's face amount (or principal) at the end of its term (or maturity). Because a bond makes fixed periodic interest payments, it's often called a fixed-income security. A bond's value constantly changes in response to interest rate fluctuations, and its price can rise or fall as the issuer's financial soundness changes.

Some bond issuers are financially stronger than others and therefore usually have higher credit quality ratings. Independent rating agencies assess an issuer's ability to pay interest and to repay the principal when the bond matures in assigning a bond's credit rating. An issuer defaults on a bond if it does not make full payments on time. Obviously, an issuer with a low credit rating pays a higher interest rate than one with a high credit rating.

## **Interest Rates and Bond Prices**

Bond prices and interest rates move in opposite directions. Simply put, when interest rates move up, bond prices go down. Conversely, when interest rates fall, bond prices rise. To illustrate, if a person invests \$1,000 in a 10-year bond with a 4% yield, interest payments will total \$40 a year. If rates rise to, say, 4.5%, other investors would be able to buy new \$1,000 bonds paying \$45 a year. Since no one would want to pay \$1,000 for the 4% bond, its price would decrease to \$960.43 to provide the same yield as the 4.5% bond. The opposite occurs if interest rates fall and new bonds are issued at a 3.5% yield. In such a scenario, the price of the original 4% bond rises to \$1,041.58 to compensate for the lower yield.

## **Bond Mutual Funds**

Bonds are fairly sophisticated instruments and require some expertise before you can comfortably trade them. That's why many investors choose to invest in bond mutual funds. (Note that whether as individual securities or in a mutual fund, bonds are subject to a number of risks, including: credit, current income, inflation, interest rate and default risk.)

The main advantage of a bond mutual fund is its convenience. A professional manager is supported by a dedicated research staff and can therefore make more informed decisions than the average individual investor. The disadvantage of a bond

mutual fund is that it has neither a fixed yield nor a contractual obligation to pay back the principal at some maturity date, the two main characteristics of individual bonds. Naturally, like other types of funds, bond mutual funds charge fees that can erode returns. And finally, because bond mutual fund managers constantly trade their positions, a bond mutual fund risk-return profile may continually change. Thus, unlike an actual bond, whose risk level tends to decline the longer it's held, a bond mutual fund can increase or decrease its risk exposure as the fund manager makes portfolio moves.

But a bond mutual fund may be worth the convenience if you don't have the time or skill to manage your own bond portfolio, or if you don't have enough money to assemble an appropriately diversified portfolio.

To learn more about retirement planning and other TIAA-CREF financial services, visit us at [www.tiaa-cref.org](http://www.tiaa-cref.org), [schedule an appointment online](#), or call a consultant at **800 842-2776**.

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