

Complete Guide to Bonds

Characteristics · Types · How They Work · How to Invest

9-Chapter Teaching Guide

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2	Key Parts of a Bond	Face value, coupon rate, maturity, YTM explained
3	Types of Bonds	9 types — fixed, floating, zero coupon, govt & more
4	Who Issues Bonds?	Government, PSUs, companies, banks, municipalities
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What is a Bond?

The big picture

A **bond** is simply a formal promise to repay borrowed money with interest. When a company or government needs money — say, to build a highway, expand a factory, or fund a new project — they can borrow from thousands of investors instead of going to a single bank. They issue bonds: written promises that say "Give me money now, I will pay you interest regularly, and return the full amount at the end."

Analogy: Imagine your friend borrows Rs.1,000 from you and gives you a written note: 'I will pay you Rs.100 every year for 5 years, and return Rs.1,000 at the end.' That written note is exactly what a bond is — just at a much larger scale.

THE TWO SIDES OF A BOND

Issuer (Borrower)	Bondholder (Lender = You)
Company or Government that needs money. Promises to pay interest and return principal.	The investor who gives money. Earns interest regularly and gets money back at maturity.
<i>Examples: Tata Motors, NHAI, Govt of India, HDFC Bank</i>	<i>Examples: Individual investors, mutual funds, insurance companies, pension funds</i>

WHAT YOU RECEIVE AS A BONDHOLDER

- **Coupon Payments:** Regular interest payments (monthly, quarterly, semi-annual, or annual) at a fixed or floating rate.
- **Principal at Maturity:** The original amount (face value) you invested is returned to you in full when the bond expires.

Key Parts of a Bond

The anatomy — understanding every term

Every bond comes with specific terms written on it. These five parts define exactly how the bond will work for you as an investor.

Term	What it means in plain English
Face Value	The amount you get back when the bond ends (matures). Also called par value or principal. Typically Rs.1,000 or Rs.10,000 per bond unit.
Coupon Rate	The interest rate the issuer pays you, expressed as a % of face value per year. Example: 8% coupon on Rs.1,000 = Rs.80 per year.
Maturity Date	The end date of the bond — when the issuer repays your full face value. Could be 1 year, 5 years, or even 40 years away.
Issue Date	The day the bond was first offered to the public. Interest calculations begin from this date.
Market Price	If you buy or sell the bond in the open market (not directly from issuer), the price can differ from face value based on demand and interest rates.
Yield to Maturity	Your actual annual return if you hold the bond until it matures. Accounts for coupon payments + any premium/discount in the purchase price.

WORKED EXAMPLE

Example: You buy a bond — Face value Rs.1,000 | Coupon 8% | Maturity 5 years

Year 1: You receive Rs.80 interest

Year 2: You receive Rs.80 interest

Year 3: You receive Rs.80 interest

Year 4: You receive Rs.80 interest

Year 5: You receive Rs.80 interest + Rs.1,000 principal returned

Total received = Rs.400 interest + Rs.1,000 principal = Rs.1,400

Bonds come in many flavours. Each type is designed to solve a different need for either the issuer or the investor. Here are the 9 most important types:

Bond Type	How it works	Best for
Fixed Rate Bond	Interest stays the same throughout the entire tenure. You know exactly what you'll earn every year.	Conservative investors who want certainty.
Floating Rate Bond	Interest changes with the market, usually linked to RBI's repo rate. When rates rise, you earn more.	Investors expecting interest rates to rise.
Zero Coupon Bond	No regular interest payments. You buy it at a discount (Rs.700) and receive full face value (Rs.1,000) at maturity. The profit is your return.	Long-term goals like children's education.
Inflation-Linked Bond	Both interest and principal automatically adjust with inflation. Protects your purchasing power.	Times of high inflation; retirees.
Government Bond (G-Sec)	Issued by the central or state government. Safest bonds in the country — fully backed by the government.	Risk-averse investors; senior citizens.
Corporate Bond	Issued by private companies. Higher interest than government bonds (up to 13%) but carries company-specific risk.	Investors seeking higher returns than FDs.
Municipal Bond	Issued by city or local governments to fund public infrastructure like roads, water supply, and sanitation.	Socially conscious investors.
Callable Bond	The company can 'call back' the bond and return your money before maturity — usually when interest rates fall.	Issuers, not investors. Be cautious as an investor.
Puttable Bond	You (the investor) can sell the bond back to the issuer before maturity if conditions change. Gives you flexibility.	Investors who want exit flexibility.

Who Issues Bonds?

Government, companies & more

In India, different types of organisations issue bonds for different purposes. Each comes with its own level of safety and return. As a general rule: the safer the issuer, the lower the interest rate offered.

Issuer	Examples	Safety Level	Typical Returns
Central Govt (via RBI)	T-bills, G-Secs, Sovereign Gold Bonds, Inflation-Indexed Bonds	Highest — backed by GOI	6.5% – 8%
State Governments	State Development Loans (SDLs) to fund fiscal deficit	Very High — near-central govt safety	6.8% – 8.5%
PSUs (Govt companies)	NTPC, NHAI, REC, PFC, IRFC	High — govt-backed enterprise	7% – 9%
Banks & NBFCs	HDFC Bank, SBI, Bajaj Finance, Shriram Finance	Medium-High — regulated	7.5% – 10%
Private Companies	Corporate bonds from listed public/private companies	Medium — company risk	8% – 13%
Municipalities	Urban Local Bodies — Pune, Hyderabad, Bhopal municipal corporations	Medium — local body credit	7% – 9%

Risk Hierarchy (Safest to Riskiest): Central Govt → State Govt → PSUs → Banks/NBFCs → Private Companies → Municipalities

As safety goes down, the interest rate offered goes up. Higher return always comes with higher risk.

Bond Ratings Explained

AAA to D — what each rating means

Before you buy a bond, you need to know: **how likely is this issuer to actually pay me back?** That is what credit rating agencies answer. In India, the main agencies are **CRISIL**, **ICRA**, and **CARE**. They study the company's finances and give a rating — just like a student gets grades in school.

Rating	Meaning	Plain English Explanation	Invest?
AAA	Highest Safety	Extremely reliable. Very low chance of default. Like lending to the most trustworthy person you know.	Yes
AA	Very Safe	Strong safety. Nearly as good as AAA. Most top banks and PSUs carry this rating.	Yes
A	Good Safety	Adequate safety. Still investment grade. Most large, well-established corporates.	Yes
BBB	Moderate	Lowest investment grade. Some risk present, but still generally okay for experienced investors.	Careful
BB	Speculative	Below investment grade. Higher risk of default if the economy worsens. Not for beginners.	Experts only
B	High Risk	High chance of default. The issuer is struggling financially.	Avoid
C	Very High Risk	Very close to default. Near-certain loss of interest or principal.	Avoid
D	In Default	The issuer has already stopped payments. Your money is at serious risk of partial or total loss.	Never

Rule of thumb: Always invest in bonds rated A or above. For beginners, stick to AAA or AA only. BBB is acceptable for experienced investors. BB and below are speculative — only for those who fully understand the risks.

Yield to Maturity (YTM)

The most important number for bond investors

YTM answers the most important question a bond investor has: *"If I hold this bond until it matures, what is my actual total return per year?"*

The coupon rate alone can be misleading. Why? Because you might buy a bond at a **premium** (paying more than face value) or at a **discount** (paying less than face value) in the open market. YTM accounts for all of this — coupons received, the price you paid, and the years remaining.

WHAT YTM INCLUDES

Coupon Payments	All the interest payments you will receive until maturity.
Capital Gain/Loss	If you paid Rs.900 for a Rs.1,000 face value bond, you gain Rs.100 at maturity. If you paid Rs.1,100, you lose Rs.100. YTM factors this in.
Time Value	Money received sooner is worth more. YTM accounts for when each payment is received.

EXAMPLE — SAME BOND, DIFFERENT PURCHASE PRICE

Scenario	Face Value	Price Paid	Coupon Rate	YTM
Buy at face value	Rs.1,000	Rs.1,000	8%	8.0%
Buy at discount	Rs.1,000	Rs.900	8%	~9.8%
Buy at premium	Rs.1,000	Rs.1,100	8%	~6.4%

Key insight: When interest rates in the market rise, bond prices fall (and YTM goes up). When market rates fall, bond prices rise (and YTM goes down). This inverse relationship between bond price and yield is one of the most important concepts in bond investing.

Advantages & Risks of Bonds

Why buy bonds — and what to watch out for

Advantages	Risks & Limitations
<p>1. Predictable income You know exactly how much you will receive and when. This makes financial planning easy.</p> <p>2. Safer than stocks Much less volatile. Bond prices do not swing wildly like share prices do.</p> <p>3. Diversification Bonds often move opposite to stocks. When markets crash, bonds hold up. They are the 'anchor' of a balanced portfolio.</p> <p>4. Legal protection If a company goes bankrupt, bondholders are paid before shareholders. You have a legal claim on the company's assets.</p> <p>5. Tax-free options Certain bonds issued by government entities (like NHA, REC) offer interest income that is 100% tax-exempt under Section 10(15) of the Income Tax Act.</p> <p>6. Beats Fixed Deposits Corporate bonds typically offer 2-5% more than bank FDs, especially after factoring in taxes on FD interest.</p>	<p>1. Inflation risk If inflation rises above your coupon rate, your real return shrinks or even becomes negative. A bond giving 7% is a loss if inflation hits 9%.</p> <p>2. Lower upside You will not get the 20-30% returns stocks can deliver in a good year. Bonds are for stability, not fast wealth.</p> <p>3. Liquidity risk Not all bonds trade actively in the market. Selling before maturity can be difficult or result in a loss.</p> <p>4. Default risk Companies (unlike the government) can fail to pay. This is why credit ratings are so important — always check before investing.</p> <p>5. Interest rate risk When market interest rates rise, older bonds at lower rates lose market value. If you must sell before maturity, you may get less than you paid.</p> <p>6. Reinvestment risk When you receive coupon payments, you must reinvest them. If rates have fallen, you cannot get the same return on that money.</p>

Before You Invest in a Bond

5-point checklist every investor must follow

Never invest in a bond without going through this checklist. Each point protects you from a different kind of loss:

1. Check the Credit Rating

Look up the bond's rating from CRISIL, ICRA, or CARE before anything else. Only invest in bonds rated A or above. For beginners, stick to AAA or AA rated bonds. A higher yield from a B-rated bond is not worth the risk of losing your entire principal.

2. Understand the Maturity Period

Short-term bonds (under 3 years) are good if you may need the money soon. Long-term bonds (10+ years) offer better returns but your money is locked. Never invest in a bond with a maturity longer than you can comfortably wait.

3. Watch out for Callable Bonds

If the bond is callable, the issuer can repay you early — usually when interest rates fall and they find cheaper borrowing. This cuts your interest income short. Always check if a bond is callable before buying.

4. Match the Bond to Your Goal

Bonds are best for: regular income needs, capital preservation, and balancing a stock-heavy portfolio. They are not ideal for fast wealth creation or beating stock market returns. Be honest about what you are trying to achieve.

5. Calculate or Verify the YTM

Always check the Yield to Maturity — not just the coupon rate. If you are buying from the open market, the bond may be at a premium or discount. YTM tells you your actual return. Compare YTM across bonds of similar ratings before deciding.

Bonds vs Other Investments

How bonds compare to stocks, FDs, gold & mutual funds

Bonds occupy a unique place in the investment landscape — safer than stocks, but with better returns than most FDs. Here is how they compare:

Feature	Bonds	Stocks	Fixed Deposits	Gold
Typical Return	6% – 13%	12% – 25%*	6% – 7.5%	8% – 10%*
Risk Level	Low to Medium	High	Very Low	Medium
Regular Income	Yes — coupons	Dividends only	Yes — interest	No
Capital Protection	Yes (at maturity)	No guarantee	Yes (insured up to Rs.5L)	Partial
Liquidity	Medium (listed bonds)	High	Low (penalties)	High
Tax on Returns	Taxable (unless tax-free bonds)	LTCG / STCG	Fully taxable	LTCG after 3 years
Inflation Protection	Partial (ILBs fully)	Yes (over long term)	No	Yes
Best for	Regular income + safety	Wealth creation	Emergency fund / safety	Hedge + store of value

* Long-term averages. Past performance does not guarantee future results.

The right mix: Younger investors (20s–30s) can hold more stocks for growth potential. As you approach retirement or need steady income, shift more into bonds. A classic rule of thumb: hold your age as a percentage in bonds (e.g., a 40-year-old keeps 40% in bonds, 60% in stocks). Adjust based on your personal risk tolerance.