Bond Fund Basics

Benefits, Risks and Portfolio Positioning

American Century Investments®

FINANCIAL FYI®

Bonds Are Essentially Loans

The borrowers, or issuers, are typically governments or corporations that agree to pay the lenders (investors) interest payments for a set period of time. At the end of a stated time frame, the bond matures, and the issuers repay investors the principal amount of the loan.

Why Invest in Bond Funds?

Bond funds invest in a variety of individual bonds and typically aim to provide investors regular income. When compared with stock funds, bond funds tend to be less volatile. These characteristics—income and the potential for less volatility—can enhance diversification and may temper overall risk.

THE ROLE OF BOND FUNDS IN YOUR PORTFOLIO

Chances are, you are considering bond funds for one or more of the reasons listed below. In addition to reviewing the benefits of each, it's also important to consider the risks.

	BENEFITS	CAUTIONS
Income	The interest (yield) that bonds pay can help provide steady investment income. In some cases, a bond fund's income can be exempt from federal and/or state income taxes.	Income is only one component of total return. Price change is the other. For some bonds (e.g., zero-coupon and inflation-indexed), price changes may have a greater influence on total return than income. Some of the highest-yielding bonds may experience significant short-term price volatility.
Diversification	Bonds typically respond differently to economic and market conditions than stocks and other investments. This can help balance a portfolio's risk and return potential.	Some types of bonds (such as high-yield corporate securities) tend to be correlated with stocks or other assets. This means they tend to move in the same direction as those assets, reducing diversification.
Capital Preservation/ Price Stability	Short-maturity bond funds (those with maturities of three years or less) tend to experience lower price volatility than longer-maturity bonds and stocks. Combining bond funds and stock funds can help produce more overall portfolio price stability than stocks alone can provide.	Some bond funds may experience significant short-term price volatility. Prices of longer-maturity bonds may rise or fall rapidly in response to changes in interest rates and inflation. Bonds with lower credit quality may experience volatility in response to changes in economic conditions. The net effect of a bond fund's short-term volatility tends to decrease over longer holding periods.

Maturity Matters

Maturity is the length of time a bond issuer has to repay the principal amount of the bond. Bond funds tend to hold bonds with similar maturities, usually grouped as short, intermediate, or long term.

You can manage your return potential and risk exposure by moving up or down the maturity spectrum.

Longer Maturity

More Potential Return
Higher yields and price appreciation when interest rates fall

More Risk
Greater volatility and potential price declines when inflation and interest rates rise

Shorter Maturity

Less Potential Return
Lower yields and price appreciation when interest rates fall

Less Risk
Limited price volatility when interest rates rise

Our research indicates the optimal combination of risk and return for bond fund investors with longer-term time horizons is in the intermediate-maturity area—generally between three to 10 years. However, investors with shorter time horizons, or who are concerned about rising interest rates, can select shorter-maturity investments with less potential price volatility.

Credit Quality Counts

Credit ratings reflect a bond issuer's financial strength and ability to make timely interest payments and repay principal at maturity. If an issuer appears to be at risk of not making payments, the value of the bond will decrease.

Bonds generally fall into two broad credit quality categories: investment-grade and high-yield.

Investment-Grade

Higher Credit Quality
Equals LOWER risk of issuer default, but LESS yield potential; investment-grade bonds are those with credit-quality ratings of BBB or higher.

High-Yield

Lower Credit Quality
Equals HIGHER risk of default, but MORE yield potential; high-yield bonds have credit-quality ratings of BB or lower.

Our fixed-income professionals believe it's important to balance bond credit quality with a diversified investment approach. Higher-quality bonds tend to zig when the stock market zags. Conversely, higher-yielding, higher-credit-risk bonds tend to move in the same general direction as stocks. A diversified bond allocation can potentially smooth out volatility and enhance performance.

Find the Right Bond Fit

Traditional bonds and bond funds play an important role in a diversified portfolio. Their main features—lower volatility, current income and diversification—will help you balance risk and return. Be sure to evaluate your circumstances, needs and preferences to determine the right bond funds for you.

Diversification cannot assure a profit or protect against a loss in a down market. Mutual fund investing involves market risk.

Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

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