Bonds — Lending Money for Steady Interest

BEGINNER LESSON EXPLAINER

What Does It Actually Mean to Own a Bond?

Unlike a stock, buying a bond doesn't make you an owner of the company or government that issued it — it makes you a lender. You hand over a fixed sum of money today in exchange for a promise: regular interest payments (called “coupons”) along the way, and your original money back (the “face value” or “principal”) on a set future date (the “maturity date”).

A useful analogy: think of a bond like lending a friend $100 in exchange for a signed IOU that says “I'll pay you back $100 in a year, plus $5 in interest along the way.” You know exactly what you're owed and when — the uncertainty is much lower than owning a slice of a business whose future profits nobody can guarantee.

Real Example: How a Treasury Bond Actually Works

David lends the U.S. government $10,000 by buying a 10-year Treasury bond with a 4.5% annual coupon rate — close to real 10-year Treasury yields today. Here's exactly what he's owed.

Annual interest payment (4.5% of $10,000)	**$450 / yr**
Total interest over 10 years	**$4,500**
Total received at maturity	**$14,500**

David knows exactly what he's owed and exactly when he'll get it — a fundamentally different deal from owning a stock, where both the “interest” (dividends) and the return of your money are never guaranteed.

Real Example: Bonds as Ballast — Two Very Different Years

Comparing AGG (a broad U.S. bond fund) against SPY (the S&P 500) in two real, very different years shows both why bonds are often called “ballast” — and why they aren't risk-free either.

Year	What happened	AGG (bonds)	SPY (stocks)
2008	Global financial crisis	+7.4%	-36.2%
2022	Rapid interest rate hikes	-12.4%	-18.6%

In 2008, bonds did exactly what “ballast” implies — while stocks fell 36%, this broad bond fund actually **gained** 7.4%, cushioning a diversified portfolio dramatically. But 2022 is the reminder to keep close by: bonds still **lost** 12.4% that year, one of their worst years on record, because rapid interest rate hikes hit bond prices hard. Bonds usually smooth the ride — they don't guarantee a smooth ride.

5 Things to Know About Bonds

1. You're a lender, not an owner — bondholders get paid before any stockholders, even in a bankruptcy.

2. Bond prices move opposite to interest rates — when rates rise, existing bond prices tend to fall, and vice versa.

3. A bond's “yield” isn't always its coupon rate — buy it above or below face value on the secondary market and your real return differs from the sticker rate.

4. Government bonds are generally considered safer than corporate bonds — but pay lower interest as a result.

5. Bonds aren't risk-free — as 2022 showed, they can still lose real value, especially when rates move quickly.

4 Things to Check Before You Buy a Bond (or Bond Fund)

Check the Maturity. Longer-maturity bonds are generally more sensitive to interest rate changes than short-term ones. Match maturity to when you'll actually need the money.

Check Who's Borrowing. Government vs. corporate, and the borrower's credit rating, affects both yield and risk. Higher yield almost always means the market sees higher risk.

Understand Yield vs. Coupon. The price you pay changes your real return, not just the sticker coupon rate. Buy below face value and your effective yield is higher than the coupon, and vice versa.

Consider a Bond Fund Instead of a Single Bond. Like ETFs for stocks, a bond fund spreads your loan across many borrowers at once, and is easier to buy and sell than an individual bond.

Worth knowing: “less volatile than stocks” doesn't mean “risk-free” — 2022 was a real reminder that rising interest rates can hurt bond prices too. Government bonds also carry different risk than corporate bonds, and no bond is completely free of the risk that the borrower fails to pay you back, though this is rare for stable governments. AGG and SPY are used here purely because they're real, well-known funds with public numbers.

Quick Check: 5 Questions

Answer all five before turning the page to check yourself against the answer key.

1. What does buying a bond actually make you, relative to the government or company that issued it?

- A. An owner with voting rights
- B. A lender, owed interest and your principal back
- C. An employee of the company
- D. A guarantor of their other debts

2. In the Treasury bond example, David's $10,000 bond paid a 4.5% annual coupon for 10 years. How much total interest did he collect over the full term?

- A. $4,500
- B. $450
- C. $45,000
- D. $10,000

3. What typically happens to existing bond prices when interest rates rise?

- A. They rise too
- B. They stay exactly the same
- C. They tend to fall
- D. They're automatically redeemed early

4. In 2008, AGG (a broad bond fund) returned about +7.4% for the year while SPY (S&P; 500) fell about -36.2%. What does this illustrate?

- A. Bonds always outperform stocks
- B. Stocks and bonds always move in exactly opposite directions
- C. Bond funds are guaranteed never to lose money
- D. Bonds can act as ballast, cushioning a portfolio during a stock market crash

5. What did 2022 show about bonds?

- A. Bonds are completely risk-free
- B. Bonds always rise when stocks fall
- C. Rising interest rates can cause bond funds to lose real value too
- D. Bond funds stopped paying interest that year

Quiz Answer Key

1 B — A bond is a loan, not an ownership stake — you're a lender, entitled to interest payments and the return of your principal, unlike a stock which makes you a part-owner.

2 A — $450 a year (4.5% of $10,000) for 10 years comes to $4,500 in total interest, on top of getting the original $10,000 back at maturity.

3 C — Bond prices and interest rates move in opposite directions — when new bonds start offering higher rates, existing lower-rate bonds become less attractive, so their price falls.

4 D — 2008 is a real example of bonds working as “ballast” — cushioning a portfolio while stocks fell sharply. That's a tendency in a crisis, not a guarantee every year.

5 C — AGG fell about 12.4% in 2022 as interest rates rose rapidly — a real reminder that “usually less volatile than stocks” doesn't mean “risk-free.”