

Weighing The High Risks And High Returns Of Junk Bonds

Junk bonds are similar to regular bonds. They are IOUs from an organization or corporation, which specify the principal amount it shall pay back. The date on which this payment of principal will be made is known as the date of maturity. The interest amount to be paid is known as the coupon. The interest that junk bonds generate is higher than that of the usual ones. These high interest payments compensate the investors for the extraordinary risks they take. These are high yield due to the high risk.

The markets rate bonds according to the credit ratings of the borrower. In the descending order of the value of the bonds, the ratings are: AAA, AA, A, BBB, BB, B, CCC, CC, C and D. Anything with a rating below BB is considered a junk bond due to the huge risk factors associated with it. In some cases, the by-laws of the group to which an investor belongs to prohibit them from purchasing bonds rated below BB. The market below a BB thus, becomes more limited than the high-grade bonds, which are known as investment grade.

Junk bonds, because of their low cost, are attractive to various investment groups. Sectors that need significant amounts of capital for operations use them extensively. Telecommunications and energy sectors are areas where they have widespread utilization. Many companies falsely show accumulated debts to receive higher ratings. This gives them the advantage to easily trade in the market. Due to this factor, many people consider junk bonds to be a form of investment fraud.

All types of bonds possess different qualities. They also differ due to the credit quality of the issuers. They fall under one of the two qualities. Lenders facing low to medium risk issue investment bonds. The interest on these is not much, as the risk of the borrowers defaulting is low. These generally receive ratings as investment grade, between AAA and BBB. The second type, are junk bonds. They give high returns, since the borrowers are in a fix and do not have any other choice. Due to the low credit ratings, it is difficult for these borrowers to acquire money at inexpensive rates.

The junk bonds can be further broken into two categories. Experts once considered the fallen angle bonds to be investment grade. However, due to the poor credit quality of the companies issuing these bonds, experts now consider them to be junk. Rising stars are the opposite of the fallen angles bonds. As the credit ratings of the issuing company improve, these bonds may turn into investment grade bonds.

Words Of Caution

One must always remember that junk bonds carry high risks. Invest wisely. Be careful of fraudulent practices concerning any type of bond, whether it is called investment grade or junk.

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