Who issues bonds, and why?

Contributed by Travis Morien

A bond is an alternative method that companies and governments can use to raise capital. When a company floats its stock, investors provide money by buying that stock, but the company then has a permanent obligation to the shareholder, in the form of dividends and other obligations.

Otherwise a company can simply borrow money. Ordinary folks usually have to get a loan from a bank or other lender, but in the world of finance there is another way. Companies sell bonds for the same reason people get a loan, because they want to borrow money but don't want to have to sell pieces of their company to do so.

They pay a fixed rate of interest on the bond, the various fluctuations in interest rates don't affect the interest payable, though they do affect the tradeable price of the bond on the bond market. Obviously if interest rates rise the desireabiliy of a bond will be reduced because you might be able to get a better deal elsewhere. This is why interest rates affect bond prices, even though the bond interest is fixed.

Bond sellers are subject to a credit rating system. "Investment grade" bonds are sold by borrowers with a good credit rating, ratings like AAA and AA denote the highest possible ratings, and because they are known as holding very little credit risk, can sell bonds with a lower interest rate than lesser companies can get. "Junk Bonds" are bonds written by companies and entrepreneurs with a very poor credit rating, no one will invest in them unless they pay a lot of interest, hence the big interest in junk bonds in the 1980s. When their business ventures failed this caused the borrowers to default on their obligations, and the junk bond market crashed.