



Bonds You May Never Have Heard Of

by Daniel McNulty ([Contact Author](#) | [Biography](#))

[Bonds](#) aren't usually seen as a hot topic, but by learning about some of the lesser known types of bonds you might wonder why. The type of bonds this article will discuss are defined by radically different terms within their indentures. These types of bonds can fit unique niches within a portfolio where traditional investment products may fall short. Other investors may choose unusual bonds to gain exposure to different kinds of risk that are uncorrelated with other assets in their portfolios. Read on for an introduction to some bonds you may never have heard of, but should get to know. (To learn more about bonds and how they can fit into your overall investment strategy, read the [Bond Basics Tutorial](#) and [Advanced Bond Concepts Tutorial](#).)

CDOs and Tranches

A [collateralized debt obligation](#) (CDO) is an aggregate asset-backed credit product that pools together many related credit products of a similar nature that differ in credit rating. From these, CDO issuers can separate the principal cash flow and the interest cash flow into two separate and independent credit products. These separated products are called [tranches](#). Tranches are then even sometimes separated into even more narrow tranches by their credit ratings. (To learn more about tranches, read [What is a tranche?](#))

With the majority of CDOs being backed by mortgages, the principal-only tranche has a known future cash flow, but at a variable rate of return, while the interest-only tranche has both an unknown cash flow and an unknown rate of return on that cash flow. Due to these unknown variables within the tranches, this creates a certain risk called [prepayment risk](#). When people pay more on these loans than is due before they mature, this increases the present value of the principal-only tranche but decreases the present value of the interest-only tranche.

The pricing of these tranches is rather complex, so we will go over broad concepts that affect the price rather than a detailed explanation of pricing models. With consumer-backed loans, particularly with mortgages, the rate of prepayment on the loan is rather predictable depending on current interest rates and economic conditions.

One instance of where these tranches would be helpful in constructing a portfolio would be in a conservatively managed fund. Here we are looking to protect and maintain capital while generating small growth. This fund could buy a highly rated, principal-only tranche and a lesser rated, interest-only tranche to fulfill its goals. This combination would protect the fund's principal from lower rated debtors defaulting, while providing exposure to a higher coupon rate from lower rated debtors. (For more on these structured products, read [Profit From Mortgage Debt With MBS](#).)

Brady Bonds

[Brady bonds](#) are U.S.-dollar denominated debt issued by non-U.S. countries, usually developing

nations. Illiquid and nonperforming debt held by financial institutions from these countries can, with the Brady bonds, be converted into sustainable, performing debt. The terms of the Brady bonds are negotiated by both sides. This then allows the financial institutions to get the nonperforming asset off their balance sheets and replace them with new assets. Brady bonds then become loans stemming from the previously non-performing debt. They also include a partial guarantee on their principal via the purchase of U.S. Treasury zero-coupon bonds, or [Treasury STRIPS](#), held in [escrow](#) by the U.S. Treasury.

The whole situation boils down to this: because a nonperforming bond is worth less than 100% of its face value, the Brady bond replaces the defunct debt as a new asset. This benefits both the [debtor](#) and the [creditor](#). Brady bonds can be used to diversify risk internationally while sparing the portfolio from concerns stemming from fluctuating currency exchange rates. (To learn more about international bonds and how they can be used to diversify your portfolio, read [Investing In Emerging Market Debt](#).)

Lottery Bonds

[Lottery bonds](#) are a type of government bond that has a chance to be randomly redeemed at a value that is higher than par value. However, some of these bonds do not pay interest, like the U.K.-premium bonds. The ones that do not pay interest compensate the buyers with a significantly higher redemption value. The ones that do pay interest resemble ordinary fixed-rate bonds. The benefit of the latter is the incentive provided by the chance that the buyer will be able to redeem the bond for more than par. These bonds tend to appeal to the general public, which also makes them aptly suited for issue by governments as a type of savings bond.

Lottery bonds find their niche outside a traditional portfolio. Savings bonds are often given as gifts to children by their elders. While the traditional bond does not suit itself well to involvement in the child's life, a lottery bond does. Bonds, such as the U.K. premium bond, can give the child a chance to be exposed monthly to the world of finance at an age when they would not understand other aspects of it. In another regard, these bonds may be of interest to investors looking to have a little fun with their portfolio.

Conclusion

The market offers many different types of bonds, but some of the lesser-known and more unique bonds available often lend themselves as solutions to problems that can arise in a portfolio. That said, each solution also brings with it new risks which need to be taken into consideration before any investment is made. As such, if these bonds are unfamiliar to you, get to know them well before buying in.

by **Daniel McNulty**, ([Contact Author](#) | [Biography](#))

Daniel McNulty graduated from Washburn University with a BBA in Finance and Economics with honors. He has long been exposed to the financial markets and deals primarily with portfolio strategy topics. McNulty says he admires the lives and works of Gaius Julius Caesar, Rene Descartes and Marcus Aurelius.

**** This article and more are available at Investopedia.com - Your Source for Investing Education ****