Bond ratings

Beginner Bonds

Just as individuals have their own credit report and rating issued by credit bureaus, bond issuers generally are evaluated by their own set of ratings agencies to assess their creditworthiness. There are three main ratings agencies that evaluate the creditworthiness of bonds: Moody's, Standard & Poor's, and Fitch. Their opinions of that creditworthiness—in other words, the issuer's financial ability to make interest payments and repay the loan in full at maturity—is what determines the bond's rating and also affects the yield the issuer must pay to entice investors. Lower-rated bonds generally offer higher yields to compensate investors for the additional risk.

How bond ratings work

Ratings agencies research the financial health of each bond issuer (including issuers of municipal bonds) and assign ratings to the bonds being offered. Each agency has a similar hierarchy to help investors assess that bond's credit quality compared to other bonds. Bonds with a rating of BBB- (on the Standard & Poor's and Fitch scale) or Baa3 (on Moody's) or better are considered "investment grade." Bonds with lower ratings are considered "speculative" and often referred to as "high yield" or "junk" bonds.

Investment Grade	Moody's	Standard & Poor's	Fitch
Strongest	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-

Non-Investment Grade	Moody's	Standard & Poor's	Fitch
	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB-	BB-
	B1	B+	B+
	B2	B	B
	B3	B-	B-
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC
Weakest	C	C	C

			D	D

Source: SIFMA; Fitch; Moody's; Standard & Poor's

Moody's, Standard & Poor's and Fitch append their ratings with an indicator to show a bond's ranking within a category. Moody's uses a numerical indicator. For example, A1 is better than A2 (but still not as good as Aa). Standard & Poor's and Fitch use a plus or minus indicator. For example, A+ is better than A, and A is better than A-.

Remember that ratings aren't perfect and can't tell you whether or not your investment will go up or down in value. Before using ratings as one factor in your investment selection process, learn about the methodologies and criteria each ratings agency employs. You might find some methods more useful than others'.

Investment grade and high yield bonds

Investors typically group bond ratings into two major categories:

Investment grade refers to bonds rated Baa3/BBB- or better.

High Yield (also referred to as "non-investment grade" or "junk" bonds) pertains to bonds rated Ba1/BB+ and lower.

You need to have a high risk tolerance to invest in high yield bonds. Because the financial health of an issuer can change—no matter if the issuer is a corporation or a municipality—the rating services can downgrade or upgrade a company's rating. It is important to monitor a bond's rating regularly. If a bond is sold before it reaches maturity, any downgrades or upgrades in the bond's rating can affect the price others are willing to pay for it.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

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Risks of fixed income investing
Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks that investors need to be aware of.

Bond prices, rates and yields
If you buy a new bond and plan to keep it to maturity, changing prices, interest rates, and yields typically do not affect you, unless the bond is called. But investors don't have to buy bonds directly from the issuer and hold them until maturity.

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