



Bond Investing 101

A bond—the most common type of fixed income investment—is essentially an “IOU” in which an investor agrees to loan money to a company or government in exchange for a predetermined interest rate. Bond mutual funds may invest in a wider variety of bonds than most individuals can afford separately. The exact type of debt the fund invests in will depend on the focus chosen by the fund’s management team. Make sure to consult the fund’s prospectus for detailed information on its investment holdings.

Key Advantages of Bond Fund Investing

- **Active management** Saves individual investors from researching creditworthiness, maturity, price, face value, coupon rate, yield and countless other factors that affect bond investing
- **Diversification** By investing in many individual bonds, even relatively small investments are diversified. When an underperforming bond is just one of many in a fund, its negative impact on an overall portfolio is lessened. Diversification, however, does not assure a profit or protect against loss
- **Automatic income reinvestment** Income from all bonds can be reinvested automatically and consistently added to the value of an investor’s account
- **Liquidity** Investors can sell shares in a bond fund at any time without regard to bond maturities.

There are many risks associated with bond fund investing, such as interest rate risk, credit risk, prepayment risk and liquidity risk. These risks are discussed below.

Learn more:

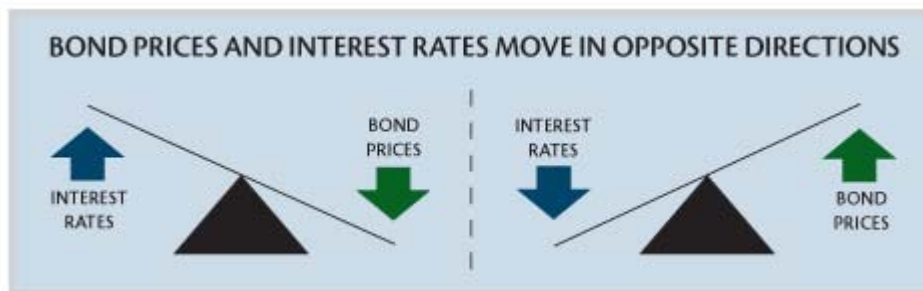
- [How Bonds Work](#)
- [Why Own Bonds?](#)
- [Choosing the Right Fixed Income Investment for You](#)

How Bonds Work

Bonds can be issued by a variety of institutions, including governments, municipalities and corporations. Many things, including market conditions, affect bond performance. However, interest rate sensitivity and credit quality tend to affect a bond’s behavior more than any other factors.

Interest Rate vs. Prices

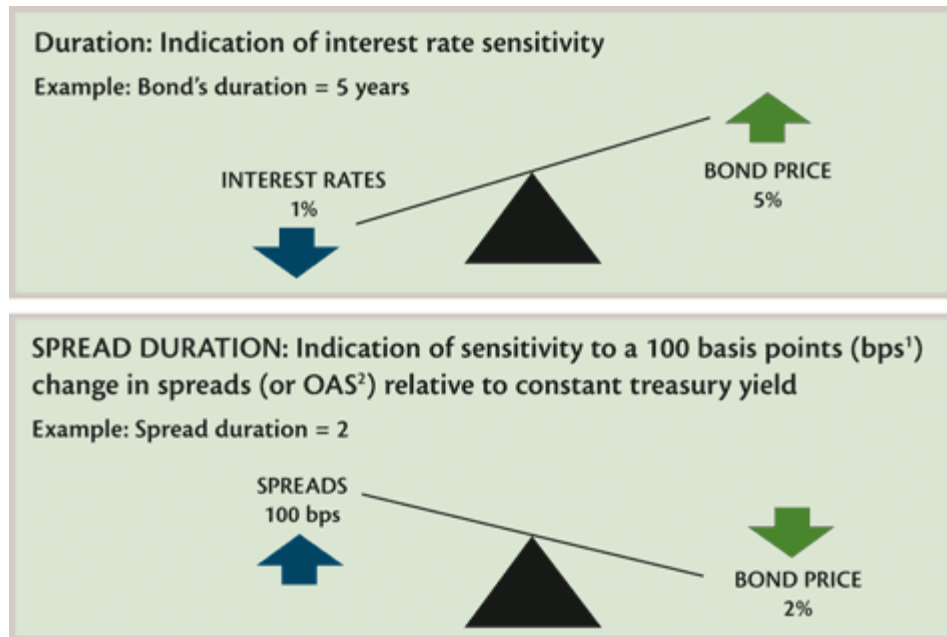
Interest rates and bond prices have an inverse relationship; when rates rise, bond prices fall and vice versa. Generally, longer term bonds are more sensitive to interest rates since there is more time for rates to change.



When interest rates fall, a bond issuer may choose to pay back the bond owner’s initial investment before the bond’s maturity date. They can then issue a new bond at a lower interest rate, but the original bond owner no longer receives regular interest payments. This is known as prepayment risk.

Duration

A bond's duration reflects the sensitivity of the bond's price to changes in interest rates. A longer duration means the bond's price will change by a greater amount in response to a change in rates.



Sometimes a change in interest rates, coupled with other economic factors, can create a smaller market for bonds and make them harder to sell. This is known as liquidity risk. However, there is no liquidity risk in government debt, and shares of a bond fund can always be sold.

Credit quality

Much like the grades you received on your report card in school, the issuing company receives a rating based on how likely it is to pay back a loan. In general, the higher the perceived risk of default (credit risk) on a fixed income instrument, the lower the credit rating.

Several independent rating agencies, including Moody's Investor Services and Standard & Poor's, use rating systems to evaluate bonds' credit quality. Figure 2 highlights how these two agencies rate bonds.

Bond Credit Rating Guide		
	Moody's	Standard & Poor's
Highest Quality	Aaa	AAA
High Quality	Aa	AA
Upper Medium	A-1, A	A
Medium	Baa-1, Baa	BBB
Speculative	Ba	BB
Highly Speculative	B, Caa	B, CCC, CC
Default	Ca, C	D

Investment grade (or high grade) bonds are considered the least likely to default

Commonly called high yield or "junk" bonds

Bond types can vary in terms of risk, return potential and maturity dates, offering investors numerous ways to potentially meet their financial goals.

Why Own Bonds?

Diversification

Higher quality bonds play an integral role in any investment portfolio. Because they don't typically move in tandem with equities, they may help lower risk in a stock-heavy portfolio, and potentially enhance a portfolio's overall returns.

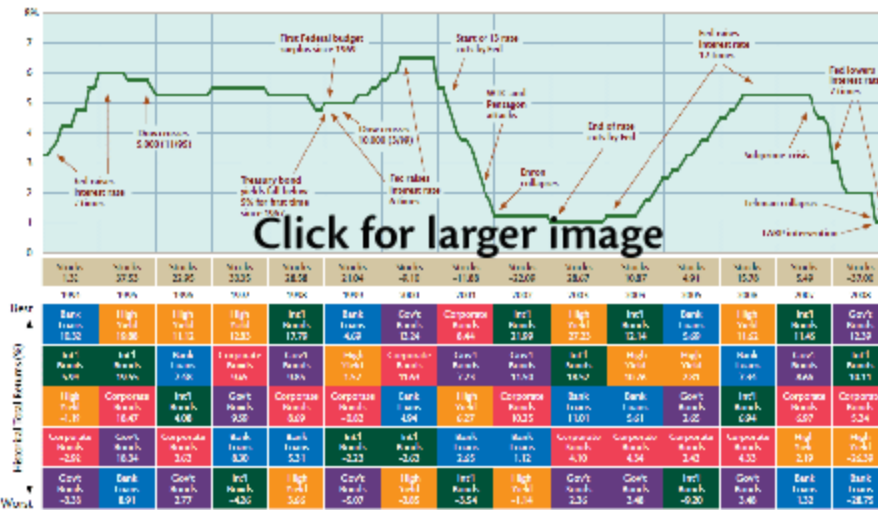
Income

Fixed income securities generally make regularly scheduled interest payments over a set period of time—typically at rates above those of cash equivalent investments such as money market funds. Steady and predictable payments make them particularly attractive to retirees and investors looking to augment their income, and may help offset losses in other parts of their portfolio.

Opportunity

At times, different sectors of the financial markets will be more attractive than others. As economic factors shift, investors may want to own securities representing those parts of the market that have the potential to offer strong returns.

Bonds can add a measure of stability to a diversified portfolio, while potentially delivering steady income.



- Bank loans are represented by the Credit Suisse First Boston (CSFB) Leveraged Loan Index, an unmanaged index that tracks the performance of senior floating rate bank loans.
- Corporate bonds are represented by the Barclays Capital Aggregate Bond Index, an index of U.S. Government and corporate bonds that includes reinvestment of dividends.
- High yield bonds are represented by the Merrill Lynch High Yield Master Index, an unmanaged market index comprised of non-investment-grade corporate bonds.
- Government bonds are represented by the Barclays Capital Government Bond Index which is composed of all publicly issued, nonconvertible, domestic debt of the U.S. Government or any agency thereof, quasi-federal corporations, or corporate debt guaranteed by the U.S. Government. Flower bonds and pass-through issues are excluded. Total return consists of price appreciation/depreciation plus income as a percentage of the original investment.
- International bonds are represented by the Citigroup Non-U.S. Dollar World Government Bond Index which is comprised of foreign government bonds with maturities over one year.
- Stocks are represented by the S&P 500 Index, a broad-based measure of domestic stock performance that includes the reinvestment of dividends.

Index performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. Indices are unmanaged and cannot be purchased directly by investors. Prior to 11/3/08, the Barclays indices were known as the Lehman Brothers indices. **Past performance does not guarantee future results.**

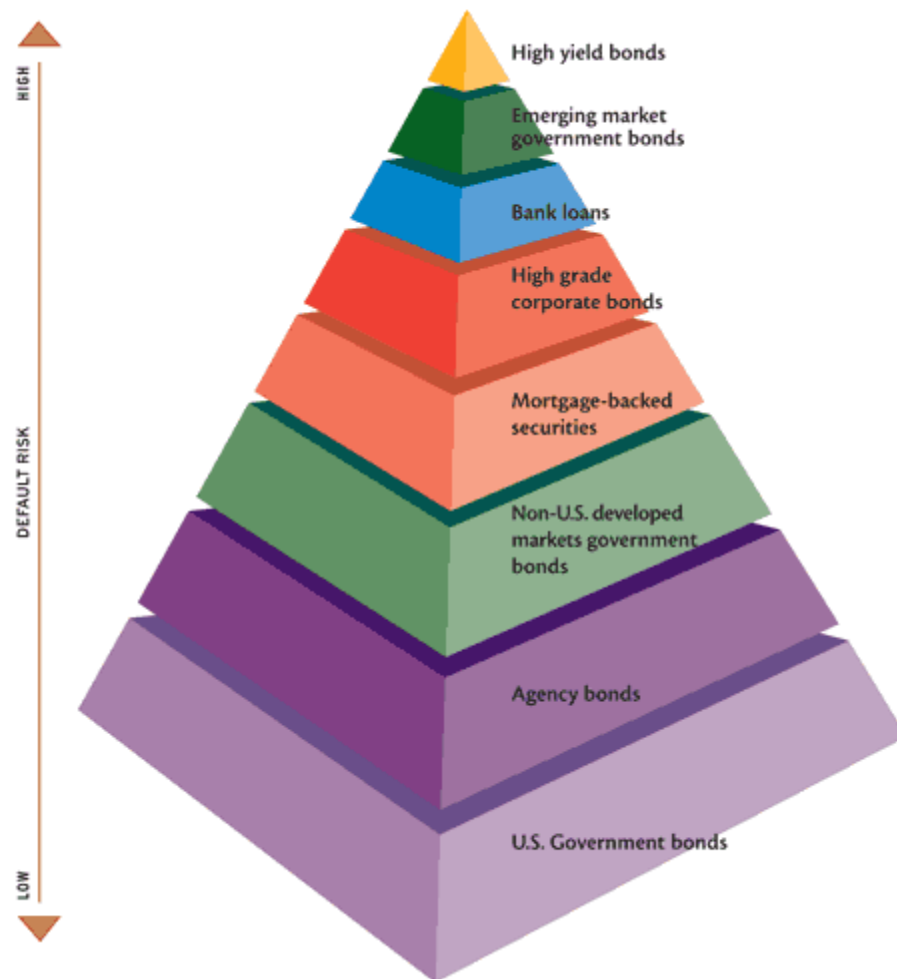
Choosing the Right Bond Investment for You

Not all bond types are the same

Different types of fixed income investments have different risk characteristics, so it's important to understand how each may function in a portfolio. U.S. Government bonds, for example, typically have the lowest correlation to stocks of any fixed income asset type, so they tend to be good diversifiers. By contrast, high yield bonds typically are more highly correlated to equities. As a result, while these tend not to offer strong diversification benefits, they may help boost a portfolio's returns when used judiciously. For help building a diversified fixed income portfolio, talk to your financial advisor.

Building a Fixed Income Portfolio from a Risk Perspective

This pyramid represents one approach to structuring a well-diversified fixed income portfolio.



Types of bonds

- **High yield bonds**

Also known as “junk” bonds, these are issued by companies with below-investment-grade ratings. Investors typically receive higher yields in return for the higher credit risk they assume. High yield bonds are also subject to liquidity risk.

- **Emerging market government bonds**

Bonds issued by governments of emerging markets such as Brazil, Mexico or Russia. These bonds have a higher risk of default, and their value may fluctuate as political conditions in these countries change. Investors are typically compensated with higher yields for the additional risk assumed.

- **Bank loans**

Sometimes known as “senior floating rate” bank loans, these are loans made primarily to non-investment-grade U.S. companies looking to finance operations. These instruments have historically provided income in excess of market rates because the loans’ rates reset periodically based on changes in market rates.

- **High grade corporate bonds**

Debt issued by corporations rated BBB or higher by Standard & Poor's. Companies that issue these types of bonds are usually large corporations with less risk of default on interest payments.

- **Mortgage-backed securities**

Banks and other lending institutions (primarily U.S. agencies) pool mortgages and offer them as securities to investors.

- **Non-U.S. developed market government bonds**

Bonds issued by governments of economically advanced foreign countries such as Great Britain, France or Japan. These bonds may include currency risk.

- **Agency bonds**

Issued by United States Government agencies, these are generally thought to be safe investments in terms of default risk. However, unlike U.S. Treasuries, they are not backed by the full faith and credit of the U.S. Government. Usually, their yield is slightly higher than that of government bonds, with very low risk.

- **U.S. Government bonds**

Backed by the U.S. Government, these bonds (also known as U.S. Treasuries) are considered to have virtually no risk of default but offer relatively low interest rates.

1. A basis point equals 1/100th of a percentage point.

2. Option-adjusted spread (OAS) is a measurement tool for evaluating price differences between similar products with different embedded options. Mainly used for fixed income products, a larger OAS implies the potential of a greater return for greater risk.

Fixed income investing entails credit and interest rate risks. When interest rates rise, bond prices generally fall, and a Fund's share price can fall. Lower rated ("junk") bonds are more at risk of default than other bond investments, and are subject to liquidity risk.

Foreign investments may be more volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic factors. Emerging and developing market investments are especially volatile.

Senior loans are typically lower rated (more at risk of default) as well as illiquid investments (which may not have a ready market).

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Two World Financial Center, 225 Liberty Street, New York, NY 10281-1008