



U.S. TREASURY SECURITIES

*Investing for maximum
safety, predictability
and liquidity*



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WHAT ARE U.S. TREASURY SECURITIES?

U.S. Treasury securities—such as bills, notes and bonds—are debt obligations of the U.S. government. When you buy a Treasury security, you are lending money to the federal government for a specified period of time.

Because these debt obligations are backed by the “full faith and credit” of the government, and thus by its ability to raise tax revenues and print currency, U.S. Treasury securities are considered the safest of all investments. They are viewed in the market as having no “credit risk,” meaning that it is virtually certain your interest and principal will be paid on time.

Because of this unique degree of safety, interest rates are generally lower than for other widely traded debt, such as corporate bonds.

The amount of marketable U.S. Treasury securities is huge, with \$3.0 trillion in outstanding bills, notes and bonds as of December 31, 2000. The Treasury market is the most liquid debt market, meaning it is the one where pricing and trading is more efficient. Trading in U.S. Treasury securities occurs virtually 24 hours a day all over the world.

In 1999, the U.S. Treasury estimated that 6% of bills, notes and bonds were held by individuals, 18% by banks and mutual funds, 18% by private nonfinancial businesses, 40% by foreign interests, 3% by state and local governments and 15% by other investors.

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The focus of this guide is on *marketable* Treasury securities, those that are of most interest to individual investors because they trade on the open market. There are other classes of Treasury debt—called *nonmarketable* securities—that are not transferable but can be purchased from and redeemed by the government. U.S. Savings Bonds fall into this category, and, even though they are non-marketable, are discussed here because they are designed for individual investors.

THE ROLE OF TREASURY SECURITIES IN AN INVESTMENT PORTFOLIO

The primary advantage of Treasury securities is safety. No other investment carries as strong a guarantee that interest and principal will be paid on time. Because these payments are predictable, many people invest in them to preserve and increase their capital and to receive a dependable income stream—to help meet living expenses during retirement, for example, or to fund specific objectives, such as paying for a college education.

The benefit of predictability is enhanced by the fact that Treasuries generally do not have “call” provision. In fact, the Treasury has not issued “callable” securities since 1985. Call provisions, common in municipal and corporate bonds, permit the issuer to pay off the bond in full before its scheduled maturity. This is especially likely to happen when interest rates decline; the issuer will refinance its debt to obtain the lower prevailing interest rate, just as home owners refinance mortgages. When that happens, the investor would be forced to pay more to

earn the same interest rate. If you own Treasuries that have no call provisions, you know exactly how long your income stream will last.

Another advantage of Treasuries is that they are available with a wide range of maturity dates. This allows an investor to structure a portfolio to specific time horizons.

Because they are the safest investments available, Treasury securities pay somewhat lower interest rates than other taxable fixed-income investments. Many investors accept this as a trade-off for security. In a diversified portfolio, Treasury securities usually represent money that investors want to keep safe from risk.

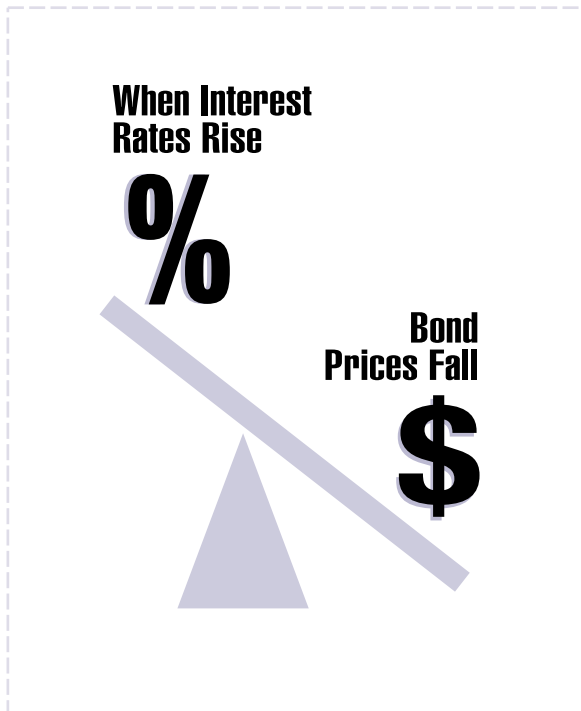
An added benefit of Treasury securities is that their interest payments are exempt from state and local income taxes (but not federal taxes). This has the effect of increasing the after-tax benefits of these investments. Investors in high-tax states should take special note of this benefit.

Another important characteristic of the Treasury market is its high level of liquidity, which means that Treasuries are easy to buy and sell. Because they trade so frequently in large volume, the spreads between what a dealer would be willing to pay and what a dealer would be willing to sell for is lower than for other securities.

MARKET RISK AND TREASURY SECURITIES

Although Treasuries are considered free from credit risk, they are affected by other types of risk, principally interest-rate risk and inflation risk. While investors are effectively guaranteed to receive interest and principal as promised, the underlying value of the bond itself may change depending on the direction of interest rates.

As with all fixed-income securities, if interest rates in general rise after a Treasury security is issued, the value of the issued security will fall, since bonds paying higher rates will come into the market. Similarly, if interest rates fall, the value of the older, higher-paying bond will rise in comparison with new issues.



In a period of low inflation and moderate shifts in interest rates, investors often are content to hold their bonds to maturity, ignoring the changes in market value of their bonds. However, some investors strive to structure their bond holdings to minimize market risks and take advantage of market opportunities. One such technique is called “laddering,” in which the portfolio is structured so that securities mature at regular intervals, allowing the investor to make new choices with available cash.

To help investors deal with inflation risk, the Treasury has created inflation-indexed notes and bonds called TIPS, and inflation-indexed savings bonds called I Bonds. They are described on pages 8 and 9.

Finally, Treasury securities, like all things that are bought and sold, are affected by the laws of supply and demand. In the late '90s, the Treasury Department began retiring the government's debt. It did this by curtailing the sale of certain securities, especially 30-year bonds, and by buying back long-dated bonds held by the public before their due dates. Together, these actions resulted in a perceived “shortage” of long-maturity Treasury securities. Prices for outstanding “long-bond” rose and yields fell. In fact, at mid-2000 an “inverted yield curve” was evident in which yields on the 30-year bonds were markedly lower than those on notes, a reversal of the usual trend.

TREASURY SECURITIES AT A GLANCE

SECURITY TYPE	MINIMUM INVESTMENT	CURRENT MATURITIES AVAILABLE*
TREASURY BILLS	\$1,000	13-WEEK, 26-WEEK AND 52-WEEK OTHER MATURITIES OFFERED BY TREASURY ON AN AS-NEEDED BASIS
TREASURY NOTES	\$1,000	2-YEAR, 5-YEAR AND 10-YEAR
TREASURY BONDS	\$1,000	30-YEAR
INFLATION-INDEXED SECURITIES	\$1,000	10-YEAR AND 30-YEAR
TREASURY STRIPS	\$1,000	6 MONTHS TO 30 YEARS
SAVINGS BONDS (SERIES EE)	\$25	PAYABLE AFTER 6 MONTHS, BUT EARNS INTEREST FOR 30 YEARS
SAVINGS BONDS (SERIES I)	\$50	PAYABLE AFTER 6 MONTHS, BUT EARNS INTEREST FOR 30 YEARS

* as of December 1, 2000

For the most current information on treasury offerings visit the Treasury's Bureau of the Public Debt Web site at www.publicdebt.treas.gov



ABOUT BILLS, NOTES AND BONDS

You don't actually receive a certificate when you buy a Treasury bill, note or bond. Your investment is tracked in a book-entry system of accounts that generates a receipt and periodic statements.

Investors need to understand the differences among Treasury bills, notes and bonds.

Treasury bills, as the table on page 6 indicates, are short-term instruments with maturities of no more than one year. They fill investment needs similar to money market funds and savings accounts. They could be a place for money an investor may need quickly for an emergency or other purposes. The Treasury bill market is highly liquid; investors can quickly convert bills to cash through a broker or bank. Treasury bills function like zero-coupon bonds. Investors buy bills at a discount from the par, or face, value and then receive the full amount when the bill matures. For example, a 26-week bill paying \$1,000 at maturity and producing an annualized yield of 6.28%, would cost \$970.28.

Treasury notes are intermediate- to long-term investments, typically issued in maturities of two, five and ten years. These might be purchased for specific future expenses, such as college tuition, or used to generate cash during retirement. Interest is paid semi-annually.

Treasury bonds cover terms of more than ten years and are currently issued only in maturities of 30 years. Interest is paid semi-annually.



OTHER TREASURY SECURITIES

Three other forms of Treasury securities available to individual investors are STRIPS, inflation-indexed securities and U.S. Savings Bonds.

Inflation-indexed securities. In 1997, the Treasury introduced notes and bonds in a new form designed to protect the investor from the effects of inflation. Using the Consumer Price Index as a guide, the value of the principal is adjusted to reflect the effects of inflation. A fixed interest rate is paid semi-annually on the adjusted amount. At maturity, if inflation has increased the value of the principal, the investor receives the higher value. If deflation has decreased the value, the investor nevertheless receives the original face amount of the security.

Here's an example of how inflation-indexed securities work. Let's say you invested \$1,000 in January on a new 10-year inflation-indexed note paying 3% interest. At mid-year, the Consumer Price Index indicates that inflation has been 1% during the first six months. Your principal is adjusted upward to \$1,010 and your interest payment (one-half of 3%) is based on that figure. Your payment is \$15.15. At the end of the year, the index indicates that inflation was 3%, which brings the value of your principal to \$1,030. Your second interest payment is \$15.45 (\$1,030 times 3% divided by 2).

Because of the built-in inflation protection, these securities usually offer lower coupon rates than Treasuries of similar maturities without the feature.

Treasury STRIPS. For many years, securities firms have offered special products to investors by separating the principal and interest components of



Treasury securities, a process called "coupon stripping." Initially, stripped securities were available only through proprietary programs of a few firms. Since 1985, the process has been facilitated through a program created by the Treasury Department—Separate Trading of Registered Interest and Principal Securities ("STRIPS"). STRIPS, also called "zero-coupon" securities or "zeros," are traded as individual securities. Stripping a bond with 20 years to maturity, for example, generates 40 coupon STRIPS (one for each semiannual coupon payment) and one principal STRIP. Once a bond is stripped, investors can buy any or all of the available STRIPS.

U.S. Savings Bonds. Popular gifts for children, the familiar Series EE savings bonds are issued in face amounts as low as \$50. You can also buy them in values as high as \$10,000. In any case, the price is half the face amount, thus the minimum investment is only \$25.

Series EE bonds accrue interest according to a floating rate (90% of the average market yields on 5-year Treasury securities) that is adjusted twice a year. The holder doesn't receive the interest until the bonds are cashed in. If the bonds are redeemed less than five years from the time they are purchased, the holder must sacrifice three-months' interest. The Treasury guarantees that Series EE bonds will mature at full face value in no more than 17 years. If you want to hold them longer, they will continue to accrue interest for 30 years.

Series I savings bonds have a built-in inflation adjustment. They are issued in the same denominations as Series EE bonds but pay interest according to an earning rate that is partly a fixed rate of return and partly adjusted for inflation. Other rules are similar, but not identical, to Series EE bonds.



Unlike most investments, Series EE and I bondholders are allowed to defer paying income taxes on the interest earned until they redeem the bonds. Under certain circumstances, the interest may be tax-deductible when it is applied against expenses for higher education.

Another type U.S. Savings Bond, Series HH bonds are available only for exchange of certain Series EE and other savings bonds.

HOW TO BUY AND SELL TREASURY SECURITIES

Treasuries can be bought and sold through an investment professional, a commercial bank or an on-line broker. They can provide you with either the most recent, “on the run” issues or “off the run” issues that are trading in the secondary market. There often is no commission charged for buying or selling Treasury securities. Dealers earn a profit by buying bonds at one price and selling them at a slightly higher price.

Some individuals prefer to buy new issues directly from the government at auction. After opening a *Treasury Direct* account with the Treasury, you can actually participate directly in Treasury auctions. If you plan to sell Treasuries held in a *Treasury Direct* account, you may use a Treasury program called *Sell Direct*[®], in which the Federal Reserve Bank of Chicago will sell your security in the secondary market for a fee. If you use the *Treasury Direct* program to buy a security and wish to sell it through a dealer, you must arrange to move it out of your account with the Treasury. You can't buy securities in the secondary market through the Treasury.

Investors may choose to invest in a mutual fund specializing in Treasuries. Some funds hold other fixed-income securities or derivatives along with Treasuries, so investors should be sure they understand the purpose of the fund and the makeup of its assets.

U.S. Savings Bonds may be purchased directly from the Treasury or from commercial banks and are often available through employee savings plans. The owner of a savings bond receives a registered certificate and, unlike other Treasury securities discussed in this guide, savings bonds cannot be re-sold or even given away.

UNDERSTANDING PRICE AND YIELD INFORMATION

There is a tremendous amount of information available on prices and yields of Treasuries from a wide variety of sources. Local and national newspapers, cable TV stations, investment advisors and a multitude of websites offer in-depth background and up-to-the-minute data. Two useful websites to look for general information are the Treasury's Bureau of the Public Debt, www.publicdebt.treas.gov and The Bond Market Association's, www.investinginbonds.com.

The price and yield of newly issued Treasuries are easy to understand. An investment of \$1,000 in a new Treasury note bought at face value paying an interest rate of 6.671% will generate \$66.71 a year in semi-annual payments.

But, as noted earlier, Treasury securities change in value in response to shifts in interest rates and market forces. How do you calculate the price and yield of a Treasury in that case?

As a first step, it's helpful to learn how to read the prices and yields that are reported in daily newspapers.

Treasury Bills. Treasury bills are quoted differently from quotes for other government obligations since Treasury bills are issued at a discount from par or face value, with the holder receiving full value at maturity.

HERE IS A TYPICAL NEWSPAPER TABLE
PUBLISHED APRIL 13, 2000.

DAYS TO					ASK
MATURITY	MATURITY	BID	ASKED	CHANGE	YIELD
MAY 25 '00	43	5.59	5.55	-0.01	5.66

- As was mentioned earlier, Treasury bills are short-term instruments with maturities of no more than one year. This particular Treasury bill matures on May 25, only 43 days away.
- The **bid** is the price at which the buyer is willing to purchase the security, while the **ask** is the price being sought for the security by the seller.
- **Change** shows that yesterday's bid price was 5.60.
- The **ask yield** is the return investors would receive if they paid the ask price and held the bond to maturity.

CONCLUSION

For investors looking for safety, predictability, and easy liquidity, Treasury securities offer a range of benefits suited to those objectives. They also offer tax advantages, and, because of the market's size, security and demand by other investors, Treasury securities represent the most liquid capital investment in the world.



GLOSSARY

Accrued interest. Interest earned on a security that has not yet been paid to the investor.

Ask price. The price being sought for the security by the investor.

Ask yield. The return an investor would receive on a Treasury security if he or she paid the ask price.

Bid price. The amount at which a buyer would purchase a security.

Book-entry. A method of recording and transferring ownership of securities electronically, eliminating the need for physical certificates.

Callable bonds. Bonds that the issuer may redeem at specified dates and prices. The Treasury has not issued callable bonds since 1985.

Coupon. The part of a bond certificate that denotes the amount of interest due, and on what date and where payment will be made. In the past, bondholders presented actual coupons to receive the interest due. Book-entry systems have made coupons obsolete, but "coupon" has become a common expression for interest rate.

Current yield. The percentage return on a bond based on its current market price and its original interest rate. A bond for which you paid \$1,000 and that pays you \$60 annually would have a current yield of 6%.

Discount. The amount by which price of a bond is less than its par or face value. Treasury bills, like zero-coupon bonds, are sold at a discount. No interest payments are made, but the investor receives the full face value when the security matures.



Face amount. Par value (principal or maturity value) of a security.

Hedge. An investment made to minimize the impact of adverse movements in interest rates or securities prices.

Issuer. The entity that issues a debt security and is obligated to pay interest and principal.

Laddering. A technique for reducing the impact of interest-rate risk by structuring a portfolio with different bond issues that mature at different dates.

Maturity. The date when the principal amount is due to be repaid.

Off-the-run Treasuries. Those sold in the secondary market rather than “on-the-run” Treasury Securities, which are those most recently issued by the Government.

Secondary market. Market for issues previously offered or sold.

Yield. The annual rate of return earned on a security. This is an expression of the relationship between the cost of the security, the interest received and the profit or loss, if any, from its sale.

Yield to maturity. A yield based on the assumption that the security remains outstanding to maturity. It represents the total of coupon payments until maturity, plus interest on interest, and whatever gain or loss is realized from the security at maturity.

Zero-coupon bond. A bond on which no periodic interest payments are made. The investor receives one payment at maturity that includes principal and interest. (See “Discount.”)



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