

What are zero coupon bonds?

Zero coupon bonds do not pay regular interest to the investor. Yet, the demand for such bonds is quite high. Here's explaining why.

Zero coupon bonds are bonds that are issued at a price lower than their face value (at a discount). However, the bond holder receives the full face value of the bond at the time of maturity. Since these bonds do not make regular interest payments (known as coupons), they are known as zero coupon bonds.

How a zero coupon bond works

These types of bonds are made available to an investor at a deep discount and no interest payment. On maturity, the investor gets the face value of the bond. When it comes down to calculation however, these bonds too pay interest. The difference between the discounted rate and the face value is the actual interest earned on the investment.

Instead of making regular interest payments on the discounted value, zero coupon bonds reinvest the interest in the bond, thereby increasing the value of the bond over time. The amount keeps accruing until the bond reaches its face value on maturity.

So, for instance, if a bond with face value of Rs 2,000 is issued at a discounted rate of Rs 1,500 for a period of two years, you still get Rs 2,000 at the end of two years. The additional Rs 500 is your interest income.

Why invest in zero coupon bonds

While absence of regular interest payments might discourage some investors, zero coupon bonds are actually a very useful instrument for many. Its long-term maturity—usually ten years or more—can help you take care of future needs like child's education, etc. Besides, its discounted rate may help you build a larger corpus over the years by investing a small amount.

Just like any other bonds, zero coupons too can be traded in the secondary market. Hence, if you wish to liquidate your investments at any point after buying them, you can do so in the secondary market at the prevailing market rates. However, in order to benefit from these bonds, it is wise to hold your investment until maturity.