A SIMPLE GUIDE TO BONDS

Henderson
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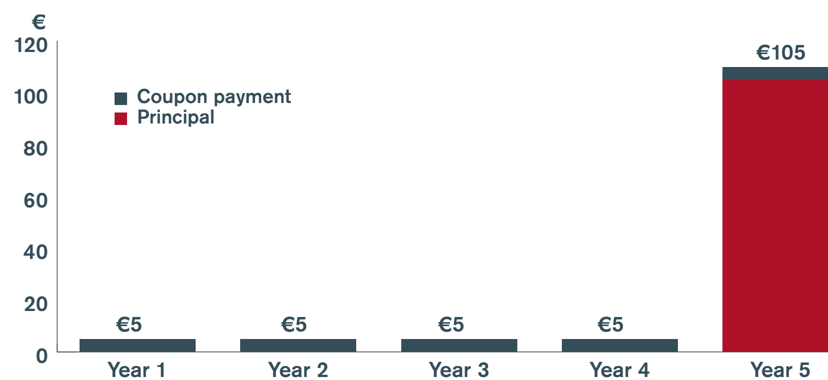
Bonds are debt securities issued by companies, governments and the like. For investors, they can provide a stream of returns. In this guide we explore their structure, why their prices go up and down, and some of the key benefits and drawbacks of investing in them. By speaking to a financial adviser, you can discuss whether investing in bonds is right for you.

What are bonds?

A bond is an IOU, typically issued by a government or company (an 'issuer'). When issued by a company, they are referred to as 'corporate bonds'. By buying a bond you are lending the issuer money. Two things are specified at the outset: the agreed rate of interest that the issuer must pay you at regular intervals (the 'coupon'), and the date at which the issuer must repay you the original amount loaned (the 'principal').

To illustrate this, let's take a fictional bond issued by Enterprise Inc. Say you buy Enterprise Inc's €100 five-year 5% coupon bond. This means you lend the company €100 and in exchange Enterprise Inc. will pay you an annual coupon of 5% (i.e. €5), and repay the principal after five years.



For illustrative purposes only

What affects the price of bonds?

Bonds can be bought and sold in the marketplace. Their prices change constantly because people in the market make different assessments on two main factors: the likelihood that the issuer will repay its debts ('credit risk'), and the effect of interest rates ('interest rate risk'). We say more about these later.

If more investors want to buy a bond than sell, the price normally increases. Similarly, if there are more sellers than buyers, the price normally goes down. The rising or falling price affects the yield of the bond. Yield is a way of measuring the attractiveness of an individual bond. However, bonds are not always held until the principal is repaid - they can be bought and sold at any time until the principal is repaid - so there are many ways of calculating the yield. The most common is the 'redemption yield'. This discounts the value of coupons received over time. It also adjusts for any difference in the price paid for the bond and the principal repaid at maturity.

However, one of the simplest is the 'running yield'. Using the earlier example, imagine that after three years, Enterprise Inc's five-year 5% coupon bond is worth €95 in the market, and another investor buys the bond from you. The coupon is still €5 – this never changes as it was agreed at the outset. The running yield would therefore be 5 ÷ 95 = 5.26%. Therefore, if bond prices fall, yields rise. If bond prices rise, yields fall.

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Risks

Interest rate risk

Imagine a government pays a 5% coupon on a bond. If bank deposit rates (the interest paid by savings accounts) were to rise to 6%, investors would be able to get a better return at the bank, and with less risk to their money. Therefore, rational investors would sell the bond, which would likely result in the price of the bond falling. Conversely, if bank deposit rates fell to 2%, the bond would represent an attractive investment and the price would likely rise.

Inflation has a similar effect. If inflation – or the expectation of inflation – rises, then the future purchasing power of the bond's coupon falls. Therefore, the bond is less attractive and the price will likely fall. Again, the converse is true in times of falling inflation.

Credit risk

This is the risk of an issuer facing financial difficulty, and failing to repay its debts (the coupons or the principal). Credit risk depends on issuer-specific factors, as well as wider economic and business conditions. For example, the US government issues bonds. It is generally accepted that the US government is very unlikely to default on its payments, and therefore their bonds carry very low credit risk. This low risk means US bonds are seen as relatively safe and the US can offer a low yield and still attract investors. However, a small company such as an oil producer in a less developed country faces far more uncertainty such as a volatile oil price, and could run into financial difficulties. It therefore carries a higher credit risk, and investors would typically demand a higher yield.

What are the benefits and drawbacks of bonds?

- Bonds are attractive to investors because they pay regular income and their prices are generally stable.
- Bonds issued by reputable companies or governments are generally considered safer than equities (company shares).
- Should a company that has issued bonds run into financial difficulty, the bond holders rank ahead of equity holders for repayment.

- The price of a bond can fall as well as rise. There is no guarantee that an issuer will not default on its obligations.
- The effects of interest rates and inflation can erode the future value of returns.

Bonds vs. other asset classes

	Capital growth	Income	Price volatility
Bonds	Moderate growth potential	Generally higher than equities. Usually stable and regular	Generally low
Equities	High growth potential	Depends on dividend and will rise and fall	Generally high
Commercial property	Moderate growth potential	Generally high and more stable than equities	Generally lower than equities
Cash	Low growth potential	Low. Depends on interest rates	Very low

The above table is a generalisation of the asset classes. Individual securities in each asset class may behave differently.

Choosing the right bonds

Investors demand a premium for the extra risk they are taking when lending money to a less well-established company or less creditworthy government. Therefore, bonds from these issuers tend to be higher yielding. Comparatively well-financed issuers are referred to as 'investment grade', while less secure issuers are referred to as 'high yield' or 'sub-investment grade'. Different types of issuers are affected in different ways. For example, government bonds tend to be more affected by changes in interest rates, while corporate bonds are more affected by the company's profitability.

Various types of bond can be issued. These include inflation-linked bonds, where payments are linked to changes in inflation, and convertible bonds, which are corporate bonds that can be converted into the company's underlying equity. Certain types of bonds may be better suited to particular economic conditions, or meeting particular investment objectives.

A credit rating can be given to an issuer, either to one of its individual debts or overall creditworthiness. The rating usually comes from credit rating agencies, such as Standard & Poor's or Fitch, which use standardised scores such as 'AAA' (a high credit rating) or 'B-' (a low credit rating).

Inefficiencies in the bond market cause potential returns available from one bond or sector to outweigh each other at different times. By carefully researching the issuers in the market, as well as considering economic and technical factors, bond fund managers aim to manage portfolios of bonds that suit the current investment conditions.

How bond fund managers perform is typically measured against an index of bonds in the region or type of issuer in which they invest. This is known as a 'benchmark'. The fund manager will aim to outperform the benchmark, as well as protect investors' capital when the wider market is falling.

Glossary

Benchmark: A standard against which a fund's performance can be measured. A benchmark is often called an index.

Commercial property: Any property used for commercial purposes. Commercial property has three main sectors: retail, office and industrial. It excludes residential property.

Coupon: A regular interest payment that is paid on a bond.

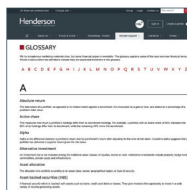
Equity: A financial security representing company ownership.

Outperform: To deliver a return greater than that of a fund's assigned benchmark.

Principal: The amount originally loaned on a bond, which must be paid back.

Volatility: The rate and extent at which the price of a fund, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Yield: The level of income on a security, typically expressed as a percentage rate.



Glossary

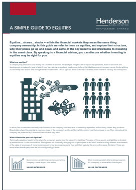
Please see **HGi.co/glossary** for a glossary of financial terms used in this document.

At a glance

- ✓ Bonds represent debt securities issued by companies, governments and the like
- ✓ Investors can benefit through a steady stream of returns
- ✓ However, this is affected by interest rates, inflation and the issuers' ability to repay their debts
- ✓ Bonds are generally lower risk than equities

By speaking to a financial adviser, you can discuss whether such an investment may be right for you.

Other educational guides in this series include:



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