Understanding Bonds

A bond is a type of debt security. They are effectively an IOU (a signed document acknowledging a debt) between a borrower (the issuer of the bond) and a lender (the investor who purchases the bond) – just as a bank deposit is effectively an IOU between the bank as borrower and the depositor as lender. When a government, corporation or other entity needs to raise money, they can borrow money from investors by issuing bonds to them.

Investors who purchase a bond from an issuer are essentially lending money to the issuer for a fixed period of time. In return, investors receive an instrument (the bond) promising that they will receive interest payments at certain intervals and also have their principal returned on a stated future date. Where the bond is quoted on a stock exchange, the investor can realize their investment by selling that bond to another investor at the current market price.

Why invest in bonds?

The investment return on a bond reflects its interest payments and any appreciation or depreciation in its price from general interest rate movements. As a general rule, the potential for capital gains or capital losses on bonds tends to be lower compared with other riskier investments.
So why are they popular investments? The main reason is that, unlike equities, bonds generally provide greater certainty to their income stream and return of capital.

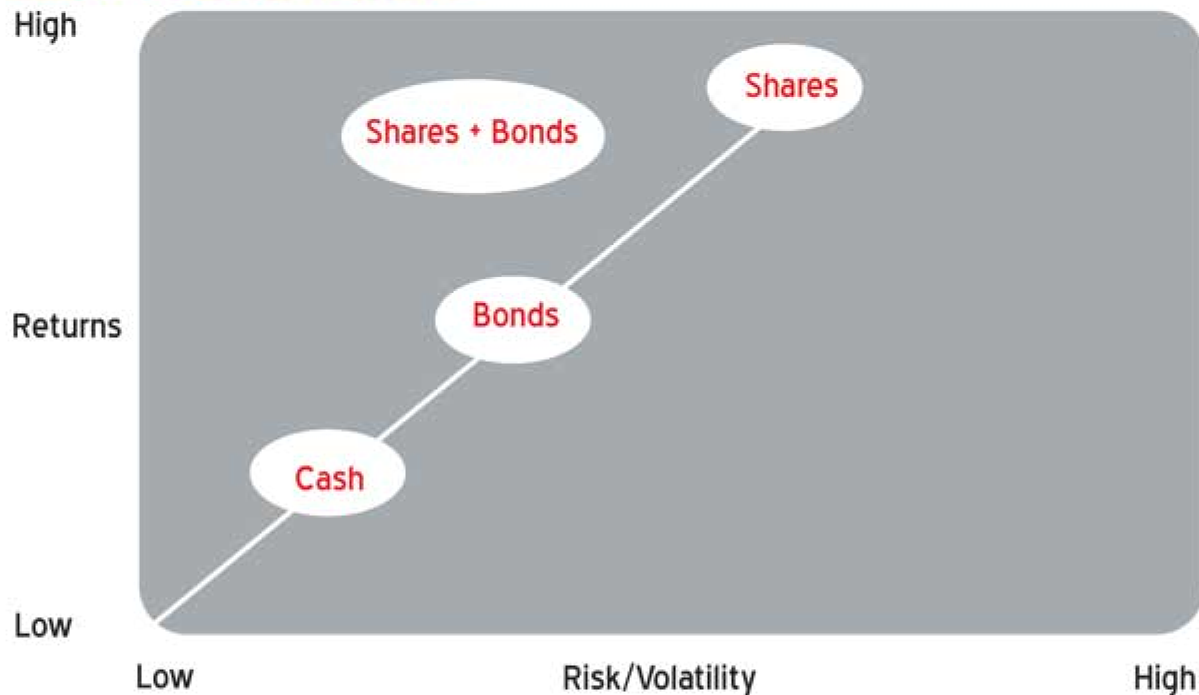
For retirees or others who need a predictable source of income, a bond's regular interest income and principal repayments at maturity provide a comforting level of security. There are other advantages too, including:

- Investment diversification, which can either reduce risk or improve a portfolio's overall rate of return (because, with bonds as an anchor for a portfolio, an investor may feel more comfortable taking on greater risk with other investible assets in the hope of achieving a greater return);
- In the case of government bonds, high levels of liquidity and security;
- The opportunity to profit from anticipated movements in interest rates.

Using bonds to diversify your portfolio

- Diversifying your investment portfolio can help reduce risk and protect returns over the longer term. Diversifying involves:
- Spreading your investments across different asset types such as shares, bonds, currencies and commodities;
- Spreading your investments within each asset type so, for example, you would hold a range of shares across different sectors and a spread of bonds of different types and with different issuers and maturity dates; and Spreading your investments across assets that have low correlation with each other, recognizing that the value of investments in different asset classes can vary through different cycles.

Bonds are a good way to introduce diversification into an investment portfolio because their regular interest payments generally provide more stable returns with lower risk attached than shares and other equity-type investments.



Risk and return – the trade off

It is important to understand the degree of risk associated with different types of investments and how that affects their expected return. Generally speaking there is a trade-off between risk and return. Assets with a higher level of risk will generally have a higher rate of return attached and vice

versa. That is why most bonds pay lower returns than shares and other riskier investments.
The diagram (See Figure 1) is designed to illustrate how a portfolio that includes a balance of shares and bonds can have a lower risk profile and more stable returns than a portfolio of shares only. This may suit investors with a desire for greater certainty of income rather than potential portfolio growth.

Comparing the returns on bonds

Evaluating the return you will make on a bond is an essential part of investment. Three different measures of rates of return are commonly used to evaluate bonds:

- Nominal yield
- Running yield
- Yield to maturity

Nominal yield measures the return on a bond based on its annual coupon payments as a percentage of its face value. This is effectively the same as

INTEREST RATES*	BOND YIELDS	FIXED-RATE BOND PRICES
Rise	Rise	Fall
Fall	Fall	Rise

In this context, interst rates should be understood as a broad term describing the general level of interest rates in the market.

the coupon rate of the bond. For a fixed rate bond, this does not change throughout the life of the bond. For a floating rate bond, it will change as the reference rate of interest changes. For an indexed bond, it will change with movements in the underlying index.
Running yield measures the return on a bond based on its annual coupon payments as a percentage of its current market price. It is a simple measure of the return the holder can expect at current market prices.
Yield to maturity is the average annual return an investor can expect to receive if they buy a bond for its market value today and hold it to maturity. The calculation factors in coupon payments, the time to and amount due at maturity and the capital gain or loss that will be made on maturity. It also assumes that the coupon payments are reinvested in the bond.

Yield to maturity is usually considered the most helpful indicator for comparing the return on bonds, as it factors in more of the variables that go to value. Comparing bonds on the basis of nominal yield is fine if they both have the same time to and amount due at maturity and you pay the same price to buy them, but if any of these things are different, a simple comparison of nominal yield will not necessarily be representative of their difference in value.

When comparing bonds, it is important to remember that yield is not the only factor that you need to take into account. As mentioned previously, bonds can have markedly different terms and conditions and you must take account of those differences when assessing the relative values of two different bonds. Also, remember the trade-off between risk and return. The fact that one bond appears to have a higher rate of return than another does not necessarily mean that it is a better investment – it could just be a riskier one.

Risks associated with bonds

Any investment carries with it some risk. This applies as much to bonds as it does to other investment types. Usually the greater the perceived risk, the higher the expected return required to compensate investors for that risk. So, bonds that are perceived to have higher risk attached will generally attract a higher coupon rate, while bonds that are perceived to have lower risk (such as government bonds) will generally attract a lower coupon rate. Some key risks to consider when investing in bonds are interest rate risk, credit risk and liquidity risk. Each of these risks is covered in more detail below.

Interest rate risk

If the coupon rate on a bond is floating, the yield on the bond can usually be expected to stay in line with current interest rates, so movements in interest rates generally should have very little impact on its price. However, if the coupon rate is fixed, the yield on the bond can only keep pace with changing interest rates if the price of the bond changes.
There is an inverse relationship between the capital price of a fixed-rate bond and expected yields – the capital price will go up if expected yields fall and will go down if expected yields rise. The same thing happens to share prices – share prices go up if expected dividend yields fall and go down if expected dividend yields rise.

Credit risk

Credit risk is related to the financial strength of the issuer. Generally, higher the credit quality of the issuer, the lower the risk associated with the bond and therefore the lower the yield required by investors. For this reason, government bonds typically pay a lower interest rate than corporate bonds and other interest rate products, because the credit risk is lower. Similarly, secured corporate bonds typically pay a lower interest rate than unsecured corporate bonds, because the credit risk is lower. However, this does not mean that your investment is risk-free. Credit risk also includes credit spread risk. This arises when investors demand a higher spread for bonds with higher credit risks compared to lower risk bonds, such as government bonds. This is often associated with a downturn in economic conditions, leading to an expectation of higher levels of default on higher risk bonds.

Liquidity or marketability risk

Liquidity risk is the risk of not being able to sell your investment quickly and easily in the market if you need to. For some corporate bonds, particularly those with small numbers on issue, liquidity may be poor.

Types and categories of bonds

Bond categories based on type of interest

- **Fixed rate bonds**

Fixed rate bonds pay a fixed rate of interest (the coupon rate) for the life of the bond. Because fixed rate bonds pay interest at a fixed rate, they carry interest rate risk as well as credit quality risk. If market interest rates rise or the financial health of the issuer deteriorates, investors will demand a greater yield and the price of the bond will fall. Governments mostly tend to issue fixed rate bonds.

- **Floating rate bonds**

Floating rate bonds make interest payments that are tied to some measure of current interest rates. Typically, the coupon will be expressed as a fixed margin above the benchmark rate. Because floating rate bonds pay interest rates that are tied to current interest rates, the major risk with them is not interest rate movements but rather credit quality. If the financial health of the issuer deteriorates, investors will demand a greater yield and the price of the bond will fall. Corporates tend to be more active in issuing floating rate bonds than governments.

Bond categories based on type of issuer

- **Government bonds**

Government bonds are generally considered to have a lower credit risk than corporate bonds and therefore may be suitable for investors seeking stable and highly secure cash flows. However, because of their lower risk, they also tend to have a lower yield to maturity. They make up the largest single pool of bonds in the market and offer a wide range of bond series. Given the size of the market, the liquidity and security of government bonds is unrivalled.

- **Corporate bonds**

There are a variety of corporate bonds. The terms of corporate bonds can vary quite markedly and therefore it is important that you read the prospectus or term sheet for an individual bond to understand its terms. It is also important that you assess the creditworthiness of the issuer of the bond as that too can vary markedly between issuers. In practice, the corporate bond market is far less liquid than for bonds issued by governments. As a general rule, safer bonds with a better credit standing promise lower yields to maturity than other corporate bonds with similar maturities.

- See more at: http://www.dailymirror.lk/92597/understanding-bonds#sthash.KAe5Npma.dpuf