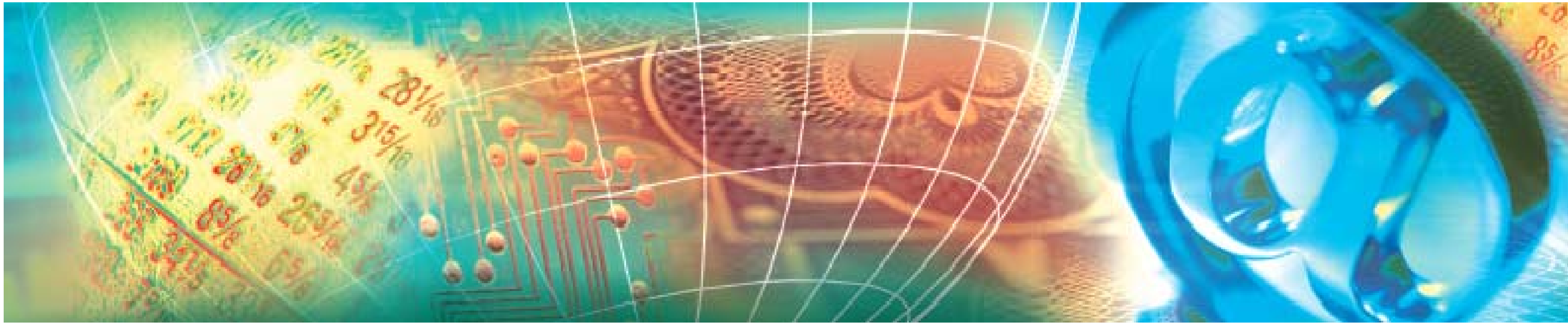

The Essential Investment: Bonds for the Private Investor

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Agenda

- Bonds are important
- Types of bonds
- Reasons to hold bonds….
- Some other important points
  - Credit ratings
  - The Yield Curve
  - Information sources

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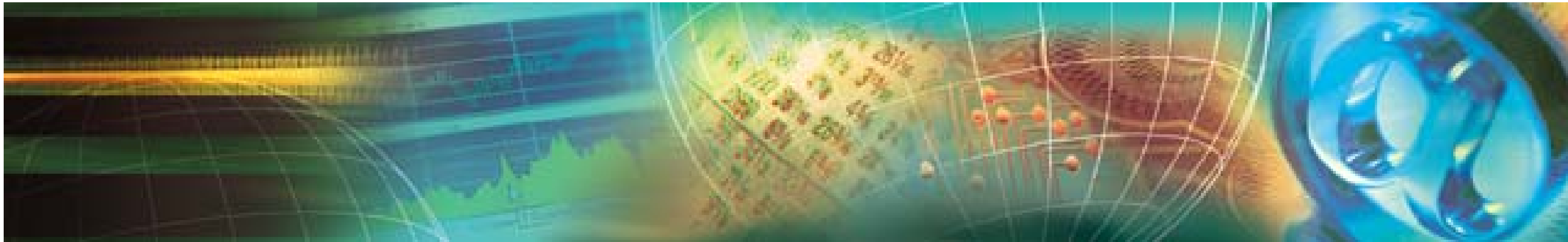
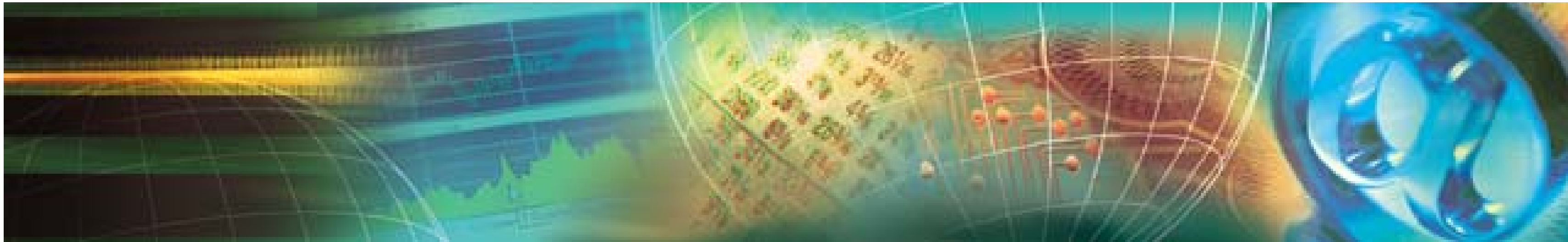


The Importance of Bonds

- **Fixed income products** or **bonds** have a great impact on your life. Their influence is felt in the wholesale as well as personal markets.
- For instance: most of us at some stage borrow money (and PAY INTEREST), whether for short- or long-term. The bond markets are where interest rates for the market are set.
- Without bonds, really important things like hospitals, airports and power stations couldn't get built.
- The market is very large and for certain issues, very liquid (meaning it is very easy to transact business in it).
- The government bond market size in UK is about £230 billion; euro-area about €1.7 trillion; US $1.9 trillion.
- If you buy bonds you are in very good company: pension fund managers, insurance companies, local authorities, banks and building societies are all large-scale buyers of bonds.
- The bond market is the **real** market indicator. Even if you only hold shares, an assessment of the debt of the company whose shares you hold will yield great insight into its fortunes and market perception.

Bond Issuers

- **Governments:** bonds issued by sovereign governments, and including the safest investment instruments available in the market.
- **Local authorities**
- **Corporates:** a very diverse market of issuers that are not governments. Range in quality from very high “AAA” to very low “junk”credit.
- Ignoring the diversity of issuers, the **benefits** of investing in bonds include:
  - Safety
  - Certainty of return
  - Fundamentally, easier to understand and analyse (!)
  - As varied a risk/return exposure as equities
  - Greater protection in bear markets
  - A way to ensure capital gain in falling interest rate environments.



Bonds versus equities

- **Bonds are "debt market" instruments**
  - We all know about borrowing money
  - Bonds are borrowed money
  - Unlike a bank loan (also borrowed money), bonds can be traded after the initial transaction
  - So different to equity which is a "share" in the company
- **Fundamental difference for investors (vs equity): rate of interest and fixed repayment date**
- **The RIGHT bond is free of risk (both capital and return)**
- **Enables separation of funding and credit risk management**
- **Returns history**
  - Over the long term we know shares produce a greater return than bonds. But the "long term" might be 40 or 50 years!
  - In the UK gilts outperformed shares in selected recent years….

Bond basics: defining a bond

- A bond is an IOU between the Issuer and the Market (who is lending the Issuer money).
- In most cases, the loan is for a fixed term, so that there is a specified **repayment** date.
- There is also (in most cases) a fixed interest rate or **coupon.**
- In other words, a bond is a package of cash flows, which are received by the bondholder at future dates until repayment.
- The price of a package of future cash flows is its “net present value”. This value will fluctuate with changes in market interest rates.
- Therefore, during its life the price of the bond will **fluctuate**, and will move towards 100 (“par”) on maturity date.

Running the numbers....

$$P = \sum_{n=1}^{N} \frac{C}{(1+r)^n} + \frac{M}{(1+r)^N}$$

where

- C is coupon payment
- M is redemption payment (100)
- r is the market-determined interest rate ir discount rate
- N is the number of interest periods to maturity

Don’t forget **clean** and **dirty** prices: latter includes accrued interest

The “*r*” above is the gross redemption yield

Types of bonds...

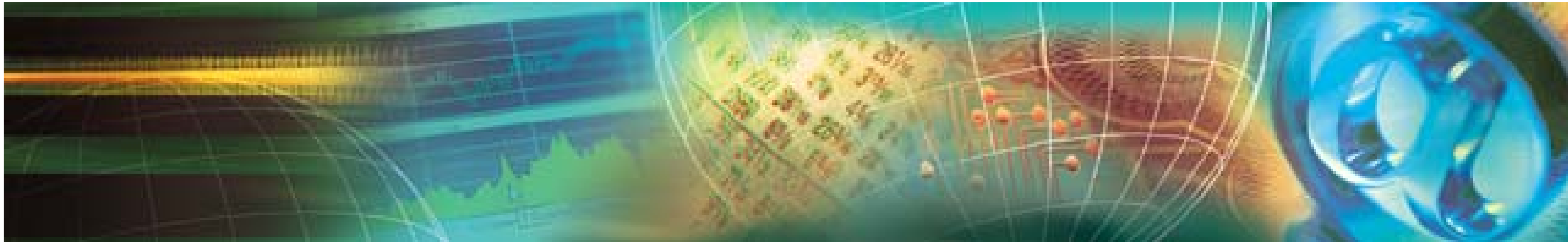
- Government bonds
- Index-linked bonds
- Zero-coupon bonds
- Corporate bonds and Eurobonds
- High yield or “junk” bonds
- Convertible bonds
- A plain vanilla bond has
  - Fixed term to maturity
  - Fixed redemption date
  - No call or put feature, or other feature (convertibility, etc)
- Lets stick to risk-free, vanilla bonds: the **essential investment.**

The essential investment

- Bonds come in a very wide variety of shapes and sizes. A large number of these are NOT suitable for private investors (we haven't even mentioned asset-backed or mortgage-backed securities!).
- BUT, the diversity of the market means that all private investors will find some instrument that suits their needs. For MOST such investors, government bonds will meet their needs, together with some very highly rated corporate bonds.
- Bond prices rise and fall with the interest rate cycle, but for quality issuers are less volatile than equity prices in all conditions.
- Bondholders have greater security than shareholders.
- Bonds are also available through unit trusts, but it's more fun to hold them individually…☺

Gilts

- Most people consider their bank savings accounts to be their safest investment.
- In fact gilts are the safest investment…
- Gilts are issued by HM government and are completely risk free. If you buy a gilt on issue, you will pay 100 per £100 nominal of stock, and receive £100 on redemption…meanwhile you will have received the annual coupon.
- In the secondary market one usually looks for gilts trading below their par value (a bit rare these days….)
- The longer-dated gilts have greater price volatility (longer **duration**) but of course are capital risk-free to redemption…
- In the falling interest-rate environment of 1990s and again after last year, gilts frequently outperformed equities…this is a bonus…
- Info on gilts available in IC, FT, www.dmo.gov.uk and www.gilt.co.uk



Credit ratings

- Remember to check your credit ratings when straying outside gilt-edged security
- The price of credit risk is given by the spread of that issue over the **risk-free** rate in that currency
- Don't forget "name recognition", where you trust a name better than its rating (eg., Nationwide BS)
- A "D" rating means default

Rating	Meaning	Examples
AAA	Gilt-edged, max safety	UK, US government
AA	High-grade, high credit quality	Italy, Canada, Abbey National
A	Upper-medium grade	Korea, Malaysia, HBoS, BT
BBB	Lower-medium grade	Morocco, Yorkshire Electricity
BB	Low grade, speculative	Brazil
B	Highly speculative	Romania
CCC	Substantial risk, poor standing	!!

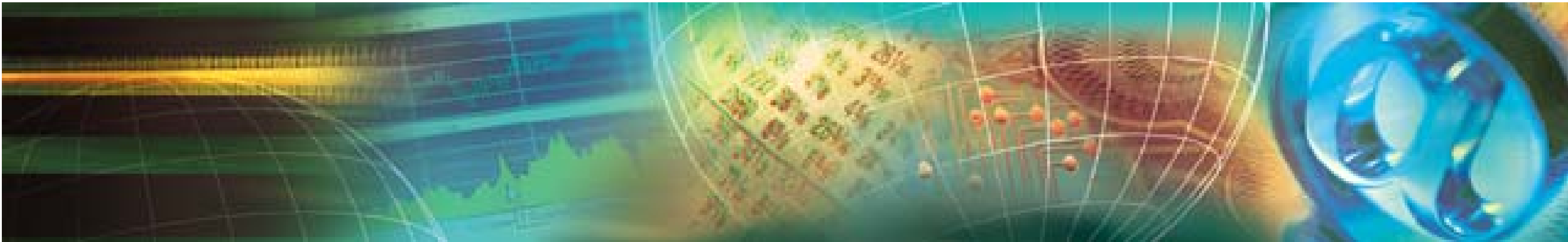
(Source: S&P; Bloomberg)

Don’t forget macro factors

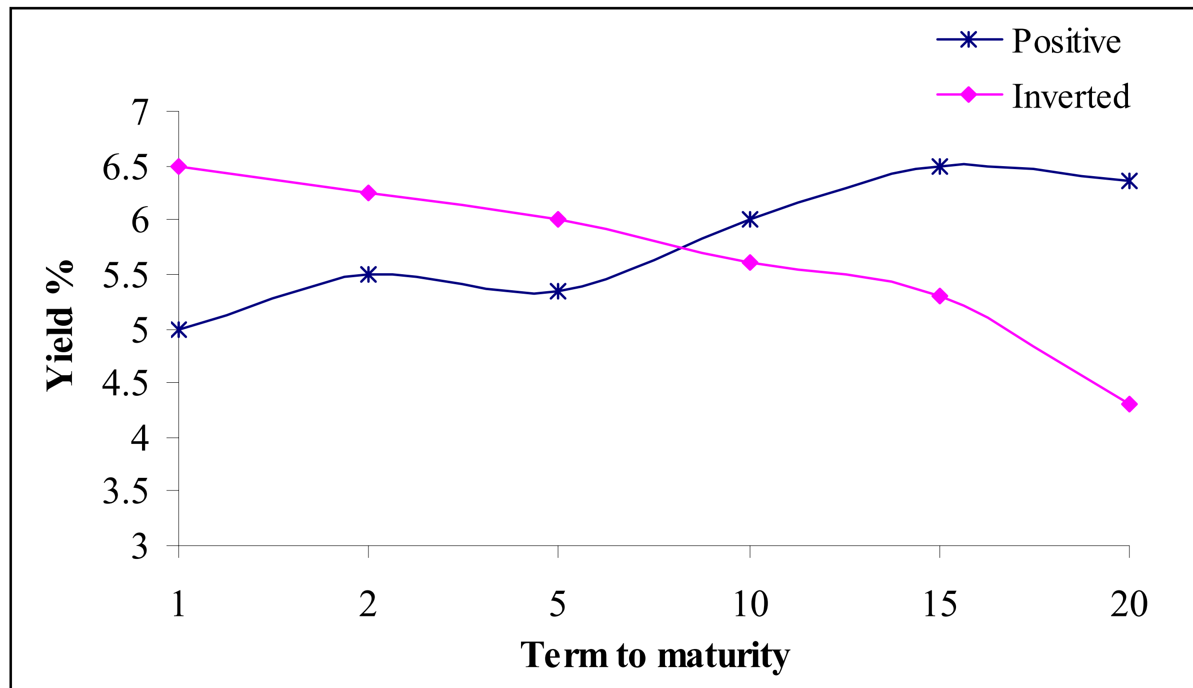
- Shareholders seem to think nothing of following economic factors to try and get an insight into future movements…..
- Actually, this is more fruitful with bond yields (prices)…they are more logically attuned to economic factors and indicators.
- The key factors are inflation and interest rates, and the money supply.
- These days the developed economies have “independent” central banks, who are tasked with keeping inflation low, either purely (ECB) or as part of overall objectives (Fed)….BoE MPC is in between these two.
- The targeting of inflation means we should pay close attention to inflation as a driver of interest rates, coupled with general state of economy (rates come down in recession, etc etc)
- The bond market has its own crystal ball for this: **the yield curve.**

The Yield Curve

- The yield curve is the only true market indicator and potential forecaster of the market
- For instance, the shape of the yield curve has correctly predicted every recession in the US since the war (The Economist)
- The yield curve is the chart that plots the yield on a group of bonds against their maturities. Only the same class of bonds can be plotted together (gilts, Treasuries, AA sterling Eurobonds, etc)
- The conventional shape of the curve is gently upward sloping – which is what we expect
- Fancy theories seek to explain curve shape (expectations hypothesis, liquidity premium, etc…)
- The curve can be inverted if market is expecting recession or for specific structural factors (eg., in gilts recently)



Yield curve shapes



You can easily set up your own yield curve in Excel…

Conclusions

- The importance of the bond market and the risk/return profile of bonds means that we cannot, as smart investors, ignore bonds or exlcude them from our portfolio
- The hype of the technology boom meant that many private investors got sucked into equities without thinking through the numbers….
- Always have some of your investment in risk-free bonds, or if you prefer something a bit risk but with higher yields, AA-rated stock such as bank debt or PIBS…(that' another story!)
- While shares might outperform in "long term", bonds are more certain under all conditions…and especially now when equities are in turmoil..a good time to access the certainty of the (say) gilt market
- At least the market movement will seem more logical to you ☺

Information sources

- www.apcims.co.uk
- www.bondresources.com
- www.calculatorweb.com
- www.investinginbonds.com
- www.longbond.com
- Investors Chronicle
- FT

Further reading

- Peter Temple, **First Steps in Bonds**, FT Prentice Hall 2002
- Michael Thomsett, **Getting Started in Bonds**, Wiley 2000
- Anthony Crescenzi, **The Strategic Bond Investor**, McGraw-Hill 2002 (a bit too dollar-market orientated…)
- Moorad Choudhry, **Bond Market Securities**, FT Prentice Hall 2001 (a bit too technical…☺
- Moorad Choudhry, **Choudhry on Bonds**, Harriman House 2002 (the essential investment ☺

www.YieldCurve.com

Fixed income market research

Publications

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Up-to-date terminology

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