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Bonds: the basics

In this article we explain exactly what bonds are and how they work in simple, no-nonsense terms.

To an investor just starting out, bonds can appear confusing. First, there are many different types of bonds – you have got corporate bonds, retail bonds, global bonds, government bonds (referred to as 'gilts' if UK government bonds) and index-linked bonds to name but a few. And we mustn't confuse these types of bonds, with fixed-term bonds (offered by banks and building societies, which are basically locking cash away for a fixed period) or Onshore or Offshore Bonds, which are tax wrappers as well as 'single premium life insurance policies.'

And then there's the jargon – what on earth is a coupon when it's at home?

Here we aim to explain exactly what bonds are and what the key terms associated with bonds mean.

What is a bond?

A bond is essentially an IOU. It refers to the debt market (primary market) or credit market. Participants can buy or sell debt securities, known as the secondary market.

You can lend your money to a company (corporate bond) or to governments in the UK or globally (Gilts/ Treasury Bills/ Bunds etc.). You lend the monies on the understanding that the bond issuer will pay you back in full on a set date, plus interest.

Since you know exactly what rate of interest you will earn at outset together with when you will get your initial investment back, bonds can be an exceptionally useful financial planning tool.

Sometimes we refer to bonds as 'fixed income' or 'fixed interest.'

FACT: The global bond market is about three times the size of the global equity market! Buyers and sellers or bonds include defined benefit pension schemes, governments, institutional investors, traders, funds etc.

Why buy bonds?

Bonds may be used to construct a well-diversified investment portfolio.

They are typically included in a portfolio for the following reasons:

1. Diversification*
2. To reduce risk (volatility)
3. To generate income (interest)

*Bonds are one of the four main asset classes, the others being: equities, property, and cash.

N.B. Bonds are not usually used to deliver high levels of capital growth. If you want the potential to see your money grow in value over the long-term, then allocate more of your monies to equities or other growth-based assets such as property.

Example of Bond (bought directly):

Now for a guide to some basic bond terminology.

Take a fictional company: 'Bonds R Us'.

Bonds R Us has decided to raise capital by issuing a 10-year sterling bond with a fixed annual coupon of 5%. The bond requires an initial minimum investment of £1,000 and is available in denominations of £100 thereafter. The offer period is between 1 Jan 2023 and 1 January 2024.

Key Terms:

Coupon:

The 'coupon' is simply a fancy word for the 'interest rate.' It dates back to the days when bond owners were issued a certificate with coupons attached which they would then rip off and hand over when it was time to claim their interest payments.

The annual interest rate or 'coupon' is expressed as a fixed percentage of the value of the bond.

So, if for example, you buy a £1,000 bond which has a coupon of 5% from Bonds R Us, this means you will net £50 in interest each year – though this is usually split into two six-monthly payments of £25.

The word 'fixed' simply means that the interest rate offered by Bonds R Us is guaranteed to stay the same for the duration of the bond term – which in this case is 10 years – regardless of what happens to interest rates, inflation and the wider economy.

'Sterling', meanwhile, just specifies you are investing in GB pounds and will earn interest paid in pounds, as opposed to a dollar bond, for example.

Offer period:

The issue date is when the bond is made available to investors, and the offer period states how long investors have to ponder their purchase – though companies retain the right to close their bond earlier if they raise the money they need quicker than expected.

On the other hand, should they not raise enough or decide they need more you might see a second issue of the same bond announced at a later date.

Once the bond's offer period is closed you will only be able to invest via the London Stock Exchange, but more on that below.

Maturity date:

This is when you are due to get your initial investment back – you might also hear it referred to as 'redemption date'. Your maturity date will depend on the term of the bond you invest in. In the case of the Bonds R Us 10-year bond above, the maturity date will be in January 2034 – 10 years on from when the bond is issued.

Duration:

The duration indicator is a complex calculation involving present value, yield, coupon, final maturity and call features. Fortunately for investors, this indicator is a standard data point provided in the presentation of comprehensive bond and bond mutual fund information. A bond's duration is often used to measure interest rate sensitivity. The bigger the duration, the greater the interest-rate risk or reward for bond prices. Bond investors often pay attention to interest rate movements because any movement up or down in rates has the opposite effect for bond prices. That is because an increase in interest rates makes an existing bond (and its now below market interest rate) worth less while a drop in interest rates increases the bond's value.

Par - The face value / par value / principal:

This is the price at which the bond is issued. It is also the amount that will be returned to whoever is holding the bond when it matures. For example, if a bond has a face value of £100, that is the amount an investor must pay to buy the bond on issue and whoever holds the bond on maturity is entitled to receive £100 back from the issuer. The face value may also be called the 'nominal value,' 'principal,' 'par value' or just 'par.'

Yield:

If you buy a bond second hand you will hear the word 'yield' a lot. It simply means the rate of return you get on the bond.

If you buy a bond at par – i.e. you pay the bond's face value – the yield is equal to the bond's coupon or interest rate. So, in the Bonds R Us example, your yield will be 5%.

However, if you buy a bond at a discount your yield will be higher than the original coupon rate, while if you pay more, it will be lower.

This is because regardless of whether you pay £800 or £1,200 for a £1,000 bond, you are still earning an annual coupon of £50. So rather than earning a 5% rate, you are actually earning 6.25% if you pay £800, and roughly 4.17% if you pay £1,200.

The calculation for this 'current yield' – or 'running yield' as you might also hear it called – is the annual interest paid divided by the price you pay for the bond times 100.

There is also something called 'yield to maturity' or 'redemption yield', which is the return you will earn if you hold the bond for the full term, including all the interest payments as well as any profit or loss you will make when you get the initial investment back at the end of the term.

Think of yield as the return you will get relative to the price. It is expressed as a percentage based on the invested amount, current market value, or face value of the security.

Income Yields

One of the main advantages of a bond is the income it produces. This is set at a fixed level relative to the original purchase price. This means if you buy a bond for £100 and the income yield is 3%, you will receive interest of £3 per year.

When interest rates are low, this can be very appealing compared to leaving your cash in the bank.

Low interest rates usually arise from low inflation. To stop prices from dropping, and inflation turning negative, central banks can reduce interest rates. This makes it more attractive to borrow and spend money rather than keep it in cash.

Central banks can increase interest rates to curb inflation (this has been happening in the UK since Dec 2021. See HERE) if prices are rising too quickly. This means it is more expensive to borrow, and more appealing to save money.

What affects the price of bonds?

The market price of a bond and therefore the yield that it offers, can be affected by a wide range of economic and stock market factors. Below, we have detailed four of the key influences that can determine how a bond will 'perform' on the open market.

Interest rates change:

Generally, when interest rates rise, bond prices fall; and when interest rates fall, bond prices rise. This is because the fixed interest on bonds looks less attractive if interest rates are high or rising but more attractive if interest rates are low or falling. The market will adjust the price of a bond, so its yield looks fair compared to the rates of interest on other investments.

Interest rates	↑
Bond prices	↓
Bond yields	↑

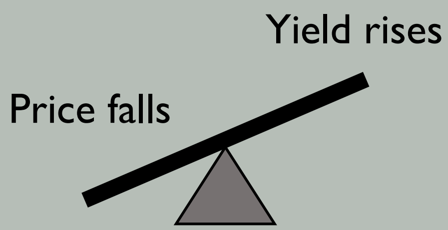
Inflation:

Rising inflation erodes the 'real' value of the fixed income on bonds. If inflation is 2% and the yield on a bond is 5% then the 'real' return on the bond is just 3%. So, if inflation falls, bonds are likely to rise in value to reflect this. Bonds tend to perform best when inflation is low and falling.

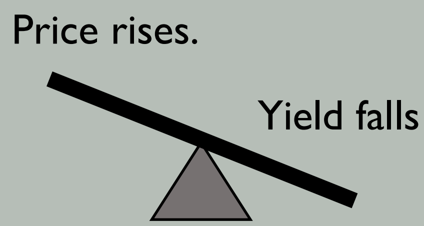
Inflation	↓
Bond prices	↑
Bond yields	↓

Bond yields are therefore affected by inflation. When inflation is high or is expected to rise in the future, it means that interest rates may increase, and investors will demand higher yields from bonds to compensate for the risk. Bond issuers need to increase their yield to appeal to investors. This then results in a price reduction of the bond because Bond Yields and Price affect each other inversely. Think of it like a **SEESAW** – when one goes up, the other comes down.

If interest rates rise:



If interest rates fall:



Government borrowing:

An announcement by the government that it is increasing its borrowings to pay for public spending tends to depress the market in government bonds. This is because the market knows the government is likely to issue more bonds. The increased supply has the effect of reducing the value of those bonds that are already on the market.

Borrow more	↑
Bond prices	↓
Bond yields	↑

Exchange rates adjust:

Investors who buy overseas non-sterling domiciled bonds can see their returns diminish if the foreign country's currency weakens in value against sterling. These investors are exposed to both the returns on the bond and the returns on foreign currency. There are constant fluctuations in foreign exchange rates, so investors need to think carefully before investing in non-sterling bonds.

£ value	↑
Overseas bond returns	↓

Price Fluctuation

Bond prices fluctuate according to supply and demand. This can be influenced by the following:

- Demand for bonds tends to increase when interest rates are low, as this can make the yield more attractive.
- However, higher demand means the price increases. This is good news for investors who already hold bonds as their portfolio will increase in value.
- But it also means that buying bonds becomes more expensive. If the price of the bond mentioned previously rises to £200, the yield will still only be £3 per year. This equates to an income of 1.5%, which is much less attractive. This naturally curbs the growth potential of bonds.
- High inflation (and high interest rates) is a different matter. Inflation will erode the 'real value' of a bond, as the capital returned at maturity will not have the same purchasing power. This makes bonds a less attractive investment.
- When equity values are increasing, this can also cause bond prices to drop as investors seek higher returns.
- The creditworthiness of the issuer will also affect bond prices. If investors believe there is a lower chance of getting their money back, they will be less inclined to invest.
- But if bond values drop, the yield becomes more valuable. Say the value of bond in the original example reduced to £50. The £3 yield is now worth 6% per year!

If you buy a bond when it is issued and keep it until maturity, fluctuating prices are not a concern, as you will still receive your interest payments and a return of capital. However, if inflation and interest rates rise in the meantime, your investment could be worth less in real terms. There is also a risk of default if the issuer becomes insolvent.

Credit Ratings:

A measure of the creditworthiness of a bond issue. This is generally provided by one of the specialist commercial credit rating agencies (for example Standard & Poors, Moody's or Fitch). For example, the highest (most favourable) rating applied to long-term debt by Standard & Poors is AAA.
AAA is the highest investment grade awarded, while anything lower than a BBB is considered non-investment grade or 'junk'. Junk bonds usually promise investors higher returns in order to compensate them for taking a greater risk – these are often referred to as 'high yield bonds.'

Credit ratings on bonds are constantly being reviewed and revised. As a broad rule, if a bond's credit rating is raised, its market price will rise, and its yield will fall. If a bond's credit rating drops, the market price will fall so the yield will rise.

Buying bonds:

You can buy and sell bonds on the London Stock exchange. Tandem Financial can buy direct corporate bonds or government bonds directly via the wrap platforms we use. However, we prefer to buy 'bond funds.' These are also called collectives (which comprise OEICS and Unit Trusts).

Owning a bond fund (compared to a single bond) means you invest in hundreds of different bonds within the fund. The trading is all done within the fund by the fund manager who can both buy and sell bonds with the fund. Collectives also tend to hold cash within the fund for liquidity purposes. This is important for when you decide to withdraw monies from your investment.

Benefits of a bond fund:

Investing through a bond fund offers a range of advantages:

- A professional investment team to manage the fund, constantly monitor the best bond positions and take care of day-to-day investment decisions.
- Exposure to typically hundreds of different bonds so investors are not reliant on the fortunes of just a couple of bonds or issuers.
- The fund manager may be able to negotiate very competitive terms when buying bonds and get access to less easily available bonds.
- Regular reports on how the fund has performed.
- Income is parcelled together and paid out in regular instalments, which is far easier than collecting income streams from lots of different bonds.
- A team of government and credit analysts who can make thorough assessments of the risks involved. For a corporate bond, it is important to have analysts who can assess the likelihood of default.

In addition, many fund managers will offer their bond funds to individuals through a tax-efficient wrapper such as an Individual Savings Account (ISA) or Personal pension plan (PPP), self-invested Pension Plan (SIPP), or Onshore or Offshore bond.*

These funds pool investors' money together which provides the opportunity for a wider choice of bonds, and thus a diversified portfolio. A professional fund manager then selects which bonds to invest in but will tend not to hold the bonds until they mature, preferring to buy and sell bonds according to their performance outlook.

Leading bond fund management houses will employ extensive teams of specialists to appraise different bonds, aiming to choose those that are offering an attractive yield at an appropriate level of risk.

Risk:

It is a common misconception among non-professional investors that bonds and bond funds are risk-free. They are not. Investors need to be aware of three main risks that can affect a bond's investment value:

1. **Credit risk** – The risk that a bonds' issuer will go into default before a bond reaches maturity.
2. **Market risk -** The risk that a bond's value will fluctuate with changing market conditions.
3. **Interest rate risk -** The risk that a bond's price will fall with rising interest rates. (The duration indicator addresses the interest rate risk.)
4. **Inflation risk** – The risk that a bond's return will not outpace inflation.

Investors need to be aware that bond prices fluctuate according to market conditions. If your bond is trading for more than you (or more likely the fund manager) initially paid for it – say £1,200 for every £1,000 you invested – it is said to be trading 'above par'. If it's trading for less – i.e. £800 for every £1,000 invested – it is trading 'below par'.

The price you get for your bond depends on how much appetite there is for the interest rate it pays.

Take the Bonds R Us bond paying 5%, for example. If interest rates rise over the next few years, you will likely find the value of your bond decreases on the secondary market as more competitive deals become available. If interest rates fall, however, you should find your bond is worth more.

Important:

Bonds are, in general considered to be less 'risky' and less volatile than equities.

- Investing in bond funds should be seen as a long-term investment.
- Bonds are not for growth. They are for diversification and reducing volatility.

Bond funds within TRAILS™:

TRAILS™ 2024 comprises three bond funds. We prefer to use bonds that have an average maturity of less than 10 years old, and we prefer to only use largely investment grade bonds which means those with a risk rating of BBB and above. We do not currently use high yield bonds, zero coupon, or emerging market debt bonds.

TRAILS™ 2024 models include:

- A medium-dated Global Bond fund (Corp & Govt bonds)
- A medium to long dated Global Bond fund (Mostly Corp Bond but with some Govt Bond)
- A UK Government Bond fund (Govt bonds)

All funds are non-predictive (passive or index) and low cost.

***N.B. All three of the TRAILS™ bond funds are available within all tax wrappers.**