CAMPBELL & McCONNACHIE

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Investing in bonds

The essential guide for newcomers to the bond market.

It is not unusual for a first-time investor to feel intimidated by the bond market. The many different types of bonds on offer, as well as the complex terminology, can deter newcomers from making their first investment.

However, bonds are an essential component for building a balanced portfolio as they are generally seen as a less risky place to put your money. Bonds can be used to help hedge against losses on some of your riskier assets.

What are bonds?

A bond is essentially a loan. When an investor buys a corporate bond, they are lending the company an amount of money for a set period of time, becoming a creditor of the company.

The issuer will pay the bondholder a fixed rate of interest (known as the coupon rate) either annually or biannually until the bond 'matures'.

The date of 'maturity' is the date when the company must pay back the amount borrowed by the investor. Bonds are traded on the market in a similar way to shares, and are thus subject to the same market forces. On a basic level, prices rise as demand increases, and fall when bonds are sold, although other factors such as interest payments and capital repayment dates can be important.

How bonds work

Understanding how bonds works means understanding 2 key terms: maturity and yields.

Maturity

Bonds are typically classified by their maturity period i.e. how long the government or company has to pay back the loan.

For example, a 2-year UK gilt issued in November 2016 will be repaid in November 2018. If a commercial bank issues a 10-year corporate bond in January 2018, it will mature in January 2028.

Yields

The bond 'yield' is a technical term for interest rate, telling the buyer how much money their investment will produce.

The **coupon yield** – or 'nominal yield' – refers to the fixed rate of interest paid to the investor after the bond is first issued. This rate will stay the same until the bond matures, regardless of what happens in the market.

The **current yield** refers to the rate of return on the bond's current market value. The current yield will ebb and flow with the market, and will rise and fall according to the bond price.

For example, if you buy a corporate 10-year bond with an interest rate (coupon yield) of 7% for £1,000, your annual return will be £70. However, the bond price rises to £1,100 and you decide to sell it. While the buyer will continue to get the 7% coupon yield on the bond's face value, the current yield will have dropped to 6.36% (70/1,100 x 100) because they paid a higher price for the bond.

Bond types

The 2 main types of bonds are corporate bonds and gilts.

Corporate bonds

Bonds provide a way for companies to raise finance from investors. The company will issue a bond paying a fixed annual rate of interest (the coupon rate) for a period of usually between 5 and 12 years.

Corporate bonds are categorised into investment-grade bonds and high-yield bonds.

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An investment-grade credit rating indicates that the company is financially sound and able to pay its debts. These bonds will be expensive to buy and offer a low return.

High-yield (or 'junk') bonds are loans to companies with less reliable finances.

You could get a higher return on your investment, but the risk is significantly higher.

Government bonds

Government bonds can carry different names such as 'gilts' or 'gilt-edged bonds'.
The important thing to remember is that they are all the same thing: an IOU issued by a government to private investors.

Government debt is rated in much the same way as corporate debt. Bonds issued by a country with an AAA rating will provide security but low returns.

Bonds issued by governments with less fiscal stability will likely be rated as junk; these bonds will offer high yields but carry higher risk.

Types of bonds compared

	Corporate	Government
Place of issue	Issued by companies onto the London Stock Exchange	Issued from the UK Debt Management Office
Maturity	Short-term (under 5 years), medium-term (5-12 years) and long-term (over 12 years)	Usually sold in 2-year, 5-year, 10-year and 30-year maturities
Returns	Higher returns	Lower returns
Risk	Higher risk	Lower risk

We can explain the differences between types of bonds.

Risk

The amount of risk you take on will be determined by several factors, including the financial health of the company/government, Bank of England policy and prevailing macroeconomic conditions.

Government bonds usually have lower yields and are more expensive to buy. They are viewed by investors as stable investments because governments are unlikely to default on their loans.

Corporate bonds tend towards higher yields because they are more risky; a company is more likely to default than a government so the issuer must offer a higher yield in order to attract investors.

Factors affecting the price and yield of bonds include:

Credit rating: bonds issued by financially-secure companies with good credit ratings will be expensive to buy and offer lower returns. If a company's credit rating is downgraded, the price will fall and the yield will rise.

Interest rate: if the bond coupon is higher than competing investments, the price will rise and the yield will fall. If it is lower, the price will fall and the yield will rise.

Inflation: higher inflation will push bond prices down because the yield will be worth less in relation to the face value of the bond.

Getting started in the bond market

There are 2 ways you can invest in the bond market: making direct investments in the market or putting your money into collective investment funds.

Direct investment

You can directly invest in both corporate and government bonds via the London Stock Exchange.

Gilts can also be bought directly from the government via its Debt Management Office.

Bonds are also available for purchase through fund supermarkets and stockbrokers.

Unlike collective investment funds, direct bond investments are not covered by the Financial Services Compensation Scheme.

Although bondholders are above shareholders in in terms of getting their money back should the company or government default on its loans, there is no guarantee of recouping all your money.

Bond funds

Funds such as unit trusts and open-ended investment companies pool your money with other investors. Fund managers will invest in a large number of bonds, allowing you to spread the risk. Most bond funds levy an annual charge of between 0.5% and 1%.

There is no maturity date with bond funds because you are not buying the bond directly.

There are 2 types of gilt funds:

- **gilt funds** contain standard, fixed-rate gilts
- **index-linked gilt funds** contain gilts whose coupon rates are linked to the Retail Prices Index measure of inflation.

There are 4 types of corporate bond funds:

- **corporate** contain investment-grade corporate bonds
- **global** invest in corporate and government bonds across the world
- **strategic** invest in wide range of bonds, including investment-grade, high-yield and bonds issued in emerging markets
- **high-yield** contain bonds issued by high-risk companies.

We can help you make decisions in the bond market that may help you to achieve your financial goals.

Important information

The way in which tax charges (or tax relief, as appropriate) are applied depends upon individual circumstances and may be subject to change in the future.

This document is solely for information purposes and nothing in this document is intended to constitute advice or a recommendation. You should not make any investment decisions based upon its content. The value of bond investments can fall as well as rise and you may not get back the amount you originally invested.

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