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INVESTMENT ADVISORS
HOLISTIC STRATEGIES

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Global Experience, Local Knowledge

Investment Basics: Bonds

Learn the basics of bonds, including the concept of price.

The bond market is by far the largest securities market in the world, providing investors with virtually limitless investment options. Many investors are familiar with aspects of the market, but as the number of new products grows, even a bond expert is challenged to keep pace. Once viewed as a means of earning interest while preserving capital, bonds have evolved into a $100 trillion global marketplace that can offer many potential benefits to investment portfolios, including attractive returns.

Before tackling the complexities of this huge and diverse market, it is important to understand the basics: What is a bond and how can bonds help meet your investment goals?

What is a bond?

A bond is a loan that the bond purchaser, or bondholder, makes to the bond issuer. Governments, corporations and stat e governments issue bonds when they need capital. An investor who buys a government bond is lending the government money. If an investor buys a corporate bond, the investor is lending the corporation money. Like a loan, a bond pays interest periodically and repays the principal at a stated time, known as maturity.

Suppose a corporation wants to build a new manufacturing plant for $1 million and decides to issue a bond offering to help pay for the plant. The corporation might decide to sell 1,000 bonds to investors for $1,000 each. In this case, the "face value" of each bond is $1,000. The corporation – now referred to as the bond issuer – determines an annual interest rate, known as the coupon, and a timeframe within which it will repay the principal, or the $1 million. To set the coupon, the issuer takes into account the prevailing interest- rate environment to ensure that the coupon is competitive with those on comparable bonds and attractive to investors. The issuer may decide to sell five-year bonds with an annual coupon of 5%. At the end of five years, the bond reaches maturity and the corporation repays the $1,000 face value to each bondholder.

Every bond also carries some risk that the issuer will "default," or fail to fully repay the loan. Independent credit rating services assess the default risk, or credit risk, of bond issuers and publish credit ratings that not only help investors evaluate risk but also help determine the interest rates on individual bonds. An issuer with a high credit rating will pay a lower interest rate than one with a low credit rating.

Again, investors who purchase bonds with low credit ratings can potentially earn higher returns, but they must bear the additional risk of default by the bond issuer.

What determines the price of a bond in the open market?

Bonds can be bought and sold in the "secondary market" after they are issued. While some bonds are traded publicly through exchanges, most trade over the counter between large broker-dealers acting on their clients' or their own behalf.

A bond's price and yield determine its value in the secondary market. Obviously, a bond must have a price at which it can be bought and sold, and a bond's yield is the actual annual return an investor can expect if the bond is held to maturity. Yield is therefore based on the purchase price of the bond as well as the coupon.

A bond's price always moves in the opposite direction of its yield, as illustrated above. The key to understanding this critical feature of the bond market is to recognise that a bond's price reflects the value of the income that it provides through its regular coupon interest payments. When prevailing interest rates fall – notably rates on government bonds – older bonds of all types become more valuable because they were sold in a higher interest- rate environment and therefore have higher coupons. Investors holding older bonds can charge a "premium" to sell them in the secondary market. On the other hand, if interest rates rise, older bonds may become less valuable because their coupons are relatively low, and older bonds therefore trade at a "discount."

Recommended Reading

One of my favourite past times is to read books. But not just any book, I like reading books by economists, because I like to evaluate their solutions to or observations of the current issues we face today.

A few months ago, I read this excellent book is 'Losing Control – the emerging threats to Western prosperity' by Stephen D King, former Chief Economist at HSBC. It was written in 2011 and traces the economic history over the past 300 years. This was written before, China-Taiwan, Ukraine-NATO-Russia issues, but proves to be remarkably prescient in its observations. A strongly recommended read for those interested in the history behind our current economic situation and a way to really understand historically the 'why'. As a bonus the writing style is excellent and there is an interesting sub-story referring to England as the world biggest drug smuggler in the 19th century!

A more recent (2023) book I read, is "It's OK to be angry about capitalism" by Bernie Sanders, the US senator from Vermont. Bernie cuts an independent path on US foreign policy but calls himself a democratic socialist and caucuses with the Democratic Party for most part. Bernie's complaint has legitimacy, in that, in recent years, most of the growth in personal wealth has gone to the top 1-2% richest groups. We are all familiar with the riots across the world, over these frustrations. Bernie's solution however shows his socialist leanings, in that he ferociously advocates for more loans write -offs, free cash to be distributed and a list of other freebies.Modern monetary theory, pushed by Stephanie Kelton and others, who have advised Bernie, which has so far said that debt can be added indefinitely as long as there is no inflation. However, it doesn't have a good answer on how to get the inflation genie, back in the bottle. So, the same old challenge remains, on which are the best fiscal policies to distribute 'the limited resources to the unlimited wants' (Robbins).

WE'RE HERE TO HELP

As you keep your long-term goals top of mind, remember: we are here to help – with news, insights and helpful resources available on our website,

www bluerocke.com or www.smefundinghub.com

to help keep you up-to-date on the latest.

Recently I was asked by a colleague at an Accountancy firm about the criteria for SME loan application and thought that it may be of interest to our community here on LinkedIn.

You likely know the five Cs of credit:

·Capital
·Character
·Capacity
·Collateral
·Conditions

These are just the basics that everyone needs to be able to have the best chance of a loan approval. And in today's market, cash reserves have become the new king. So, my advice to clients is to let your light shine bright and to put your best foot forward in providing detailed information to your lender, including:

·Credit history – be honest
·Real estate – if you own something (even if it's mortgaged) it's better than no real estate
·Track record of business success / expertise and why you make the difference

If you are interest in a loan for your Small to Medium business then check out my blog at www.smefundinghub.com and feel free to reach out to Dev to find out more.

Congratulations to the Matilda's on their efforts in the World Cup. While we are all disappointed with the team being eliminated against England, we are all so proud of them all and excited what this will do for female sport here in Australia.

Well done team!