BONDS

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What is a bond?

A bond is a type of investment that represents a loan between a borrower and a lender. Think of it as similar to getting a personal loan from a bank – except in this case you are the lender (known as the investor or creditor) and the borrower is generally, a government or corporation (known as the issuer).

With bonds, the issuer promises to make regular interest payments to the investor at a specified rate (the coupon rate) on the amount it has borrowed (the face amount) until a specified date (the maturity date). Once the bond matures, the interest payments stop and the issuer is required to repay the face amount of the principal to the investor.

Because the interest payments are made generally at set periods of time and are fairly predictable, bonds are often called fixed-income securities.

How are bonds different from stocks?

Bonds are considered debt investments. On the other hand, a stock purchase is considered an equity investment because the investor (also known as the stockholder) becomes a part owner of the corporation.

The issuers of stock or equity are typically companies; issuers of debt can be either companies or governments. While bonds generally don't provide an opportunity to share in the profits of the corporation, the stockholder is entitled to receive a portion of the profits and may also be given voting rights. Bondholders earn interest while stockholders typically receive dividends. Both may experience capital gains or capital losses if the price at which they sell their holdings is, respectively, higher or lower than the price at which they bought them.

Coupon rates are most often fixed – the rate of interest stays constant throughout the life of the bond. However, some bonds have variable or floating coupon rates (interest payments change from period to period based on a predetermined schedule or formula). Some bonds pay no interest at all until maturity.

Because bondholders are creditors rather than part owners, if a corporation goes bankrupt, bondholders have a higher claim on assets than stockholders. This provides added security to the bond investor – but does not eliminate risk. Finally, bonds also trade differently from stocks. Bonds typically trade in the over the counter (OTC) market – for example, from a broker to a broker at another firm directly – instead of on a stock exchange.

WHAT ARE THE BENEFITS OF INVESTING IN BONDS?

Income predictability

If your objective is to maintain a specific, steady level of income from your portfolio, high quality bonds can provide a series of predictable cash flows with minimal risk to your invested capital (the principal).

Safety

Depending on their quality, bonds can offer you a high degree of certainty that the interest and principal repayment will be received in full if the bond is held to maturity. The quality of the bond – and the level of security that comes with it – is reflected in the credit rating of the issuer.

Diversification

Diversification means holding a mix of different asset classes in your portfolio. For example, adding fixed-income securities like bonds to an equity portfolio helps you achieve greater diversification. This is a way to reduce portfolio risk – the risk inherent in your combined investment holdings – while potentially increasing returns over time, since even if one class declines in value, there is still an opportunity for an increase in one or more of the other classes.

Choice

A wide range of bond issuers with a variety of coupon rates and maturity dates are available for you to choose from. This allows you to find the bond(s) with cash flows that match your income needs while complementing your other portfolio holdings.

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WHAT ARE THE RISKS OF BOND INVESTING?

There are a number of risks to bond investing and, as a rule, investment returns are lower when risk is low; higher returns mean higher risk. Two key risks are the risk of default and price risk.

The risk of default (also known as credit risk)

An issuer of debt is said to be in default when the issuer is unable to repay the principle or interest as scheduled. Government of Slovakia bonds have virtually no risk of default. Corporate bonds are more exposed to default risk because companies cannot raise taxes when there is a cash shortfall or take advantage of other options available to governments.

Because the financial health of a company may change during the life of a bond, it is important to watch for changes. Investors can assess the likelihood of default inherent in a bond by watching its credit rating.

Price risk

If you sell your bonds prior to their maturity, their price or market value may be lower than the price at which you bought them. Price fluctuates throughout a bond’s lifetime and may be greater or less than its face or principal value.

If you buy a bond below par, you can expect to realize a capital gain when the bond matures; similarly, if you bought the bond at a premium, you will have a capital loss at maturity.

A bond’s price is a function of the bond’s coupon rate as compared to the current level of interest, its remaining term to maturity, its credit or default risk and any special features it may have.

Term to maturity

As bonds approach maturity, their market value approaches their face value. In general, the longer the term to maturity and the lower the coupon rate, the more sensitive a bond is to any changes in rate. When interest rates increase, bonds with distant maturity dates and low coupon rates experience the greatest fall in price.

Risk

As a rule, you can expect to receive a full repayment of a bond’s face value on the maturity date as long as the issuer is able to repay the debt, but if the credit rating changes during the life of the bond, it may have an affect on the bond’s price. For example, if the credit rating of debt rated “AAA” – the lowest level of default risk – changes due to large losses by the issuing company that could affect the

company's ability to repay interest or principal, the bond price will drop even if there is no change in interest rates.

Special features

Many bonds have special features that may have a significant impact on their price, risk and the returns you may earn. They can be called (repaid) early or they can be converted, for example, into shares of the issuing company. Bonds can also be extended (repayment deferred from the original term to a later date) or other special provisions can apply.

Demand and supply

The availability of bonds and the demand for them also affects the price of bonds. As demand increases, prices rise, all other factors remaining the same. Also, as the supply of bonds declines, for example, prices generally also rise. In both cases, if you are holding bonds, their yield to maturity will increase. Similarly, when demand falls or supply increases, prices fall and yield to maturity declines.

HOW DO I INVEST IN BONDS?

There are three common ways to invest in bonds:

1. Over-the-counter (OTC) market: Individual bonds are not bought on a central exchange such as the Toronto Stock Exchange (TSX) (except in the case of convertible debentures). Instead, they are bought or sold through an investment advisor from inventory in the advisor's brokerage firm or in the OTC market. The price includes any fees for the advisor's services.

When purchasing a newly issued bond (a bond not previously held by another investor), the investment advisor provides you with a prospectus or other disclosure documents that explain the bond's terms, features and associated risks and then buys the bond on your behalf in the primary market. Previously issued bonds are traded in the secondary market.

2. Mutual/investment funds: Bond or balanced mutual funds are an indirect method of investing in bonds. These products combine professional management with exposure to a basket of bonds that have varying maturity dates and levels of quality.

Like any mutual fund, a bond or balanced fund may accommodate systematic purchase/withdrawal plans, reinvestment of distributions and low initial investment requirements.

However, unlike direct bond investments, mutual funds do not have a stated maturity date or coupon rate, making the size and timing of your cash flows uncertain. It may also be difficult to determine the quality of the bonds held in the fund or the general level of risk. Mutual funds charge investors a management fee that incorporates fees paid out to advisors.

3. Exchange-traded funds (ETFs): ETFs are mutual fund trusts whose units trade on a stock exchange, such as the TSX. Some ETFs expose you to an entire bond market index, while others try to track the performance of a government benchmark bond. Risk levels vary depending on the ETF selected. Because ETFs are not actively managed, they tend to be characterized by lower management fees.