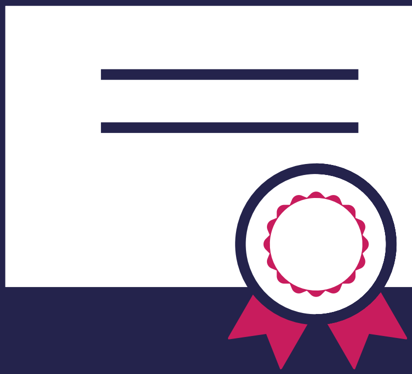
Aberdeen Standard Investments

A guide to bonds

Bonds

Bonds are a type of loan and have been in existence for thousands of years. Governments and companies issue bonds to finance major projects that require heavy spending. The first bond issued by the UK government was in 1693, to pay for a war against France.



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What is a bond?

A bond is effectively a loan to an institution – say, a government or a company that needs to raise money. When you buy a bond from an institution you're lending them your money for a predetermined period of time.

In return, you'll receive a promise of regular interest payments, known as coupons. At the end of the agreed period you'll also get back the original amount you paid. For example, a bond with 10 years to maturity offers to pay out interest for 10 years from the date it's issued. At the end of the 10 years (the redemption date), the bond issuer promises to repay the amount originally lent, and the interest payments will stop.

If you want, you can sell a bond before the end of the agreed period. But if you do that, the amount you get back depends on how much the bond is worth on the open market. Its value will go up and down depending on supply and demand, and other factors like interest rates and inflation (see 'How can you make money?' on the next page). You may also see bonds referred to as fixed interest or fixed income investments. That's because you get interest payments at a set rate for a set period of time.

Bonds issued by the UK government are known as Gilts, while bonds from companies are called corporate bonds.

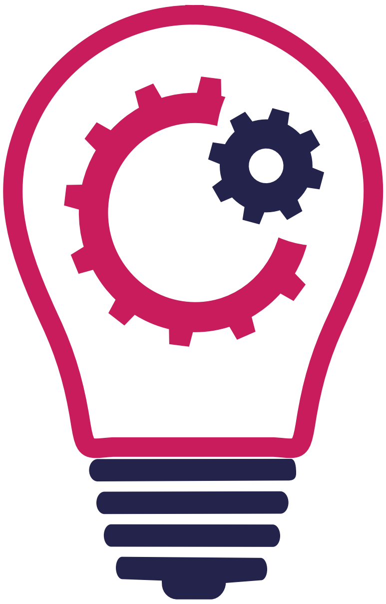
You may also hear about other government bonds such as Treasuries and Bunds, which are US and German government bonds respectively.

Why invest in bonds?

Most people tend to think about equities (or shares) when it comes to investing. While share prices might rise or fall sharply in response to news stories and announcements of company profits, investing in bonds is generally seen as safer, reducing the risk of potential loss.

There are several reasons why an investor might wish to buy bonds. These include:

- a steady and defined income, as you get a fixed level of interest when you invest in them direct
- capital preservation, often making them suitable for investors (such as those approaching retirement) who don't want to risk losing money they have saved
- spreading risk when used as part of a diversified investment portfolio. This is because different types of investment act in different ways and can go up and down at different times.



How can you make money?

1. Income

When a government or company issues a bond, it offers a rate of interest, known as the coupon rate.

This is determined by a variety of factors, including:

- the general level of interest rates at the time
- the period of time until the bond matures, and
- the credit rating of the issuer (see Grading risk on the next page for further explanation).

So if you buy £100,000 worth of bonds from Vodafone and the coupon rate is 5%, Vodafone promises to pay you £5,000 a year in interest.

2. Capital gains

Many investors don't hold bonds until they mature. If you want money back before the bond matures, you can sell it through a broker – either at a gain or at a loss.

A number of factors can cause the price of a bond to fluctuate.

- **Credit rating:** This reflects the likelihood of the bond issuer failing to pay what it owes to investors. If a company's circumstances have changed, the credit quality of the issuer may have improved or deteriorated. If it's the latter, the value of the bond will fall, as other investors will be less willing to take it off your hands without some discount to reflect the extra risk that the company will not be able to make the payments due. Government bonds also have a credit rating. This tends to be higher than for companies, as it is more common for companies to fail to pay what it owes (or to 'default'). The US and UK governments have never defaulted on a payment to bond holders.
- **Interest rates:** Typically, when interest rates are low, bond prices are high, and vice versa. If interest rates rise, investors get a higher reward for keeping their money in the bank. This is risk free, so the relative attraction of bonds goes down and investors need a higher incentive to invest in bonds. When interest rates rise, the price of bonds therefore goes down. Put another way, let's say you bought the Vodafone bond with a coupon of 5% that we talked about earlier. Then Vodafone issues new bonds with a coupon rate of 10%. This would result in no one wanting to buy your 5% bond because they could buy the newly issued bond that pays a higher rate of 10%. So for your bond to become attractive to other investors it needs to fall in price until it also yields 10% relative to the price they paid for it. This works the other way too. So if interest rates fall, you can sell your bond at a profit.
- **Inflation:** When you buy a bond, it usually promises fixed interest payments. So a rise in inflation means these payments won't buy you as much. As a result, the prices of bonds tend to fall as they're less attractive. Conversely, if inflation is low, bond interest payments will be worth more, so the prices of bonds tend to rise as they're more attractive.
- **Supply and demand:** A sudden surge in companies or governments that need to borrow can mean there will be many bonds for investors to choose from. Prices would then be likely to fall. But if there are more investors wanting to buy than there are bonds on offer, prices are likely to rise.

How can you lose money?

Because bonds are considered lower risk than equities, many investors use bonds to reduce the risk in their portfolios. But they aren't risk free.

It's extremely unlikely that the UK government would ever default on its obligations to pay bondholders. It never has before. However, there's a chance that some companies or governments – particularly in more volatile countries – might not be able to keep up the payments. To compensate for this risk, these bonds often offer a higher rate of interest. But if the issuer defaults, you run the risk of losing some – or even all – of your investment.

Grading risk

No investment is completely risk free. In general, the higher the returns you're aiming for, the more risk you'll need to take.

In the same way that individuals have a credit rating, allowing companies to decide if they want to offer us loans or mortgages, there's a system that identifies which bonds are the safest and which are more risky. Bonds are normally graded according to the government's or company's creditworthiness. This gives investors an indication of their ability to pay interest and to repay bondholders at the redemption date.

Ratings agencies tend to give government bonds AAA or AA ratings as they're considered higher quality, and therefore a safer option, than corporate bonds. Some countries and their governments are considered safer than others. Bonds with a rating of BBB or above are considered to be 'investment grade', while those with a rating below this are considered to be 'high yield'.

Investment-grade bonds are lower risk as you're unlikely to lose money. On the flip side, interest payments tend to be lower. High-yield bonds are higher risk but will generally offer higher interest payments.

How to invest

While you can invest directly into bonds, it can be a risky strategy to have all your money in one government or company. This is why many people choose to invest through funds. That way, an investment manager pools your money with that of other investors to buy a range of bonds.

Including bonds in an investment portfolio, alongside other types of investment, can be an effective way of lowering your overall risk. Bonds tend to behave in a different way to equities. This can make them useful for spreading risk. Historically, they've been less prone to sharp and sudden market movements than equities. However, at certain times they can be very risky. Some types of bond can be at least as volatile as equities.

Investing through a bond fund also gives you the benefit of having an experienced fund manager invest and manage your money for you.

There are many different kinds of fund, with their own levels of risk. Whichever route you choose, we'd always recommend that you speak to a financial adviser before you make an investment decision. If you don't already have a financial adviser and would like to find one in your area, take a look at www.unbiased.co.uk.

Types of fund include:

Government bond funds

Invest primarily in government bonds

Country- or region-specific funds

Invest in bonds from one country or region (e.g. the UK, Japan, emerging markets)

High-yield bond funds

Invest primarily in riskier, high yield bonds (i.e. rated below investment grade)

Corporate bond funds

Invest primarily in corporate bonds

Style-specific funds

Focus on providing investors with a particular outcome, such as paying an income

Aggregate bond funds

Invest in a mix of government and corporate bonds

Tracker funds

Invest in a portfolio that tracks a particular bond index

Definitions

Equity

(n) shares in a company that can be bought and sold on a stock market

Bonds

(n) debenture, a security, issued by a government or a company when borrowing money

Multi-asset

multi- combining form meaning much or many; asset *(n)* an item of monetary value e.g. she invested in a multi-asset portfolio

Important Information

This information is to help you understand more about bonds, how they work and why you might want to invest in this asset class and all the risks.

The value of investments, and the income from them, can go down as well as up and investors may get back less than the amount invested. Past performance is not a guide to future results.

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