

Investing in Bonds

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What is a Bond?

- A debt instrument issued by a Government or company which can be traded as a security in a similar way to an ordinary share in a company but with significant differences explored in this presentation
- Each bond will have
 - An issue date - when it was first sold
 - A coupon or interest rate payable – typically payable annually, semi-annually or quarterly
 - A maturity date (the date where the bond has to be repaid by the borrower(issuer)) or a call date (the date where the issuer has the right but not the obligation to repay the bond)
 - Terms and conditions as detailed in the prospectus – These may relate to options around early redemption, the conditions under which coupons can be missed and for corporate bonds details on the bond's position in the hierarchy of creditors on the company's Balance Sheet

Types of Bonds

- The main types of bonds are
 - Corporate Bonds – issued by corporations, banks, insurance companies
 - Government Bonds – issued by countries (e.g. UK- Gilts, US-Treasuries, Germany-Bunds)
- These bonds can be issued in different forms
 - Conventional bonds – with fixed coupons and fixed maturities
 - Indexed Linked Bonds – with coupons and capital linked to inflation
 - Perpetual Bonds – with no fixed maturity dates but usually with call option dates allowing the issuer to buy back the bond at certain dates in the future

How The Bond Market Works?

- Bonds have been issued and traded since at least the 18th Century !
- The bond market (the secondary market) allows bond holders to sell their bonds ahead of maturity to raise cash and for those with cash to buy existing bonds second hand as well as new bonds at issue
- Bonds are bought at offer and sold at bid prices and the less liquid a bond is the bigger the spread will be between these two prices
- Bonds are bought and sold with accrued interest so that a buyer pays the going price for the bond plus the accrued interest since the last coupon payment and the seller gets the face value plus the accrued interest
- Bonds trade in 'parcels' - some in parcels of £1,000 making them suitable for smaller portfolios, but generally the smallest parcel is £50,000 or £100,000 making them inaccessible to those with portfolios less than £1m

What is my return from investing in a bond?

- If you buy a bond at 100 at issue and hold it to maturity then your return is simple to calculate - it is the coupon payable each year.
- If you buy and/or sell a bond in the market your return can be very different as bond prices can vary significantly during the term of the bond. In this case your return will be the coupon income as a percentage of your cost of purchase and then you may get an additional capital gain/loss depending on whether you sell the bond or it matures for more or less than you bought it.
- In any event it is quite simple to forecast the return to maturity, or call date, annual income generated and returns to a date in the future prior to maturity making an assumption about future interest rates.
- In general terms bonds fall in capital value when interest rates rise and will rise in capital value when interest rates fall.
- Corporate bonds will fall in value if the risk of default worsens and will rise in value if the risk of default improves.
- Bonds with longer terms to maturity will have bigger capital swings than shorter dated bonds as changes in interest rates and credit risk get compounded over many years.

How safe is investing in bonds?

- As is so often the case there is no generalisation that can be made. The level of risk will entirely depend on the bond chosen. For example looking at two extremes:
 - A very low risk bond would be a shorter bond, say less than 5 years to maturity, in a strong country or company like a utility, with little business risk.
 - At the other extreme would be a Greek bond bought now with a high risk of default and uncertain recovery value post-default.
- Higher price risk does not have to come with credit worthiness, it can come with long term interest rate movements. For example it could be high risk to buy a very long dated US or UK Government bond with the intention of selling it well before its maturity date. If the interest rate outlook rose significantly in the early years of holding such a bond its capital value would fall significantly.
- Conversely, long dated Government bonds have delivered excellent, stable returns over the past 20 years as interest rates have fallen consistently over the period.

Bond vs Equity investing

- Two big issues separate bond investing from equity investing:
 - The priority in the capital structure of a company for bond holders over equity holders
 - The smaller number of variables involved in forecasting future returns for bond holders versus equity holders

Bond vs Equity investing

Priority over Equity holders makes owning bonds generally safer than owning equities

- In most cases, in the event of a company going into liquidation, bond holders will be repaid ahead of equity holders.
- The priority of coupons on bonds is almost always ahead of dividends for shareholders, so for example, whilst shareholders in BP and Lloyds went without dividends after their respective crisis, bond holders continued to receive interest coupons.
- When companies need to raise capital bond holders are normally immune to the diluting effect that a rights issue has on existing shareholders. There were plenty of examples of this in the aftermath of the credit crisis.
- The fact that most companies have a layer of bond holders effectively leverages returns for shareholders, this is good news when revenues increase but like all leveraged vehicles exaggerates losses for shareholders when revenues fall.

Bond vs Equity investing

Table 1: Variables impacting future returns – 6 & 7 making equity investing more speculative

Bond Variables	Equity Variables
1. Coupon	1. Current Profitability
2. Maturity date or planned sale date	2. Planned holding period
3. Credit risk and Balance Sheet cushion before bond holders are at risk	3. Balance Sheet leverage to judge how profits and losses will be magnified by company's borrowings
4. Interest rate outlook over planned holding period	4. Interest rate outlook over planned holding period
5. Currency exchange rate if not in GBP	5. Currency exchange rate for non UK share or company with overseas earnings
	6. Ability of company to increase profits in line or ahead of current forecasts
	7. Price of multiples to earnings and book value at the time of purchase and forecast at the planned date of sale

Why invest in Corporate Bonds now?

- The interest rate outlook remains sanguine despite recent inflation. It seems Governments of indebted nations are reluctant to raise interest rates in the face of economic uncertainty.
- Corporate Balance Sheets are strong in many cases with significant reparations since the 2008 crisis, some voluntary, some forced by regulation e.g. in the financial sector.
- Credit risk fears have been high so corporate bond prices are suppressed and yields are much more attractive than on Government bonds.
- There is a significant amount of capital raising still to do which is going to keep supply high and prices attractive.
- Some financial institutions are being forced to sell some bonds, or buy back their own bonds which will no longer count for regulatory capital.
- When buying bonds we only need concern ourselves with the ability of the company to remain in business and to be credit worthy, we don't need them to increase revenues and profits year-on-year.
- By contrast the outlook for shareholders in big companies remains challenged in respect of points 6 and 7 from Table 1
 - Excessive valuations from the late 90's are still being unwound as investors get more risk averse
 - Economic growth is slowing again as austerity measures bite and credit continues to shrink making it harder for companies to increase revenues and lowering expectations of future growth
 - Inflation negatively impacts companies' cost bases and makes it hard for them to increase profits
 - The taxation of companies will likely get tougher as Governments seek to increase revenue resulting in lower profits after tax

How do I invest in Bonds?

- As with shares it is possible to own bonds directly in a stock broking account. Those with portfolios less than £1m will need to focus on small parcel bonds.
- For those with SIPP and ISA portfolios bonds are an ideal investment as coupons can be earned tax free.
- Broad passive exposure can be acquired through ETF's.
- Actively managed portfolios can be accessed through funds.
- In the UK bond funds are mostly open-ended OIECs or UCITs. OIECs will tend to be broadly vanilla buy and hold funds, UCITs will have greater flexibility to hedge currency and interest rate exposures and to protect capital values in falling markets.

Notes

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