

understanding fixed interest

WHAT IS FIXED INTEREST?

One of the most common types of fixed interest security is a bond. A bond is simply a loan. When investors buy bonds, they are lending money to the borrower (also called the 'issuer'). The borrower is usually obliged to pay interest at regular intervals on the money they have borrowed, as well as repay the principal at the end of an agreed time, the maturity date. The maturity date can vary, but can be short term (0-2 years), medium term (2-10 years), or long term (10-30 years).

The key characteristics of a bond are shown in Graph 1. In this example, an investor makes an initial \$10,000 investment in a 10 year bond that pays 5%pa interest. The investor receives a fixed \$500 per year in interest (5% x \$10,000) for the 10 years, as well as the repayment of the original capital at the end of the 10 years.

DIFFERENT TYPES OF BONDS

There are many different types of bonds with varying degrees of risk:

Government bonds - These are bonds issued by governments needing to raise cash. They are generally considered to be the least risky type of bond and typically

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offer the lowest rate of return. Bonds issued by less developed nations may offer higher returns to compensate for their possible higher risk.

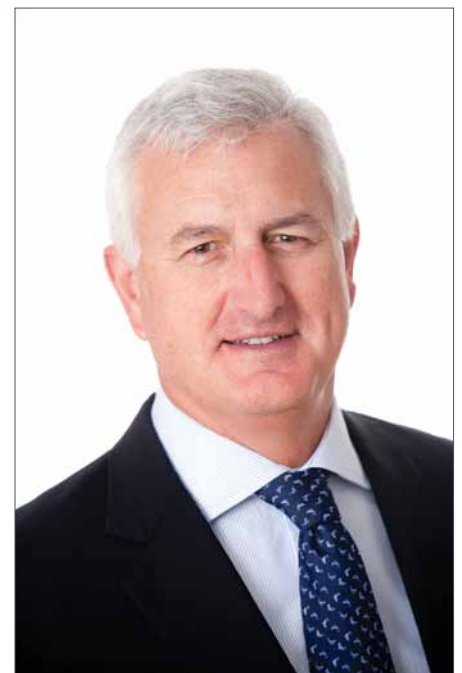
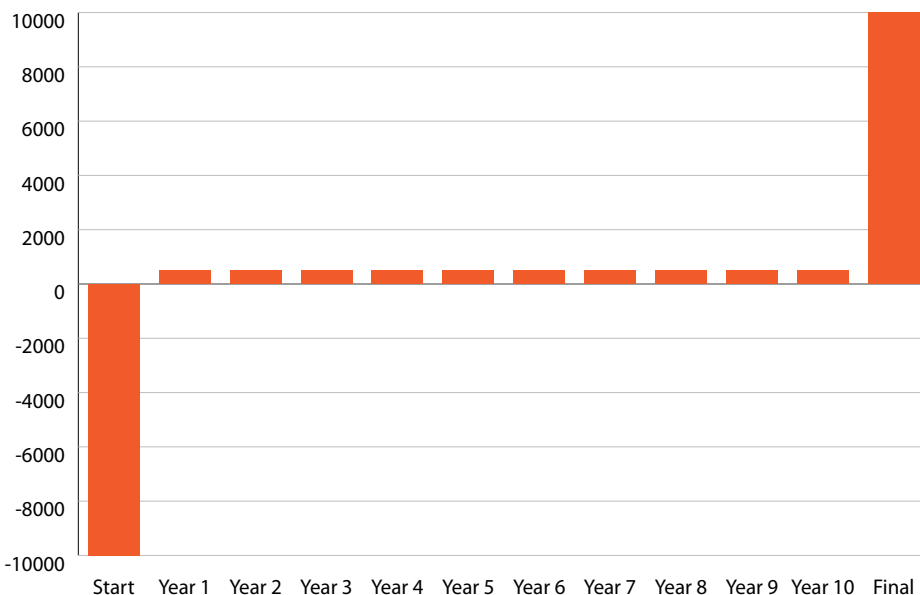
Semi-government bonds - These are bonds issued by Australian state or territory governments and are considered safe investments, given the high credit rating of the states and territories.

Supranational bonds - These bonds are issued by institutions such as the World Bank and European Investment Bank.

Corporate bonds - These bonds are issued by companies, usually to raise money to expand business or fund particular operations. They offer higher returns than government bonds due to their perceived higher credit risk. The higher return, or credit spread, is the difference in income between a corporate bond and a government bond of equivalent maturity. The credit spread is an indicator of the higher risk of default and the lower liquidity of the corporate bond.

High Yield bonds - These are corporate bonds that are rated below Investment Grade. Because the issuing company has a higher risk of default than an

Graph 1: Cashflows for a 10 Year Bond (\$)



This article by Patrick Bennett (above), Head of Research.

Investment Grade company, their bonds typically have to pay a higher yield to compensate for the additional risk and to make them attractive to investors.

Securitised bonds - These are bonds created by pooling the cashflows from similar types of loans. Examples include mortgage backed securities, created by pooling a large number of mortgage loan repayments. These can be relatively risky, depending entirely on the quality of the underlying assets that generate the cashflows.

THE RELATIONSHIP BETWEEN BONDS AND INTEREST RATES

The payments to a bond investor are fixed at the time of the initial loan. (In the example shown in Graph 1, the investor receives 5% pa). Should interest rates rise, say to 7%, investors would be able to get a higher return on their money

elsewhere and the price of the bond would fall as it becomes less attractive. However, as the bond price falls, the yield on the bond (its income ÷ its price) would rise as the fixed 5%pa income increases relative to its lower price. Conversely, if interest rates fall, say to 3%, the price of the bond would rise because its 5% return would be more attractive to an investor than the market's 3%. However, the yield on the bond would fall as its fixed 5%pa income diminishes relative to its new higher price.

WHAT ARE THE MAIN RISKS?

Fixed interest is usually regarded as a relatively safe investment asset class. However, like any investment it does carry some risks. The major risks include:

Interest rate risk – As discussed above, bond values fluctuate as interest rates change. When interest rates rise, the capital value of a bond will fall, and vice

versa. In times of frequent and large changes in interest rates, the impact on bond returns and yields can be very significant.

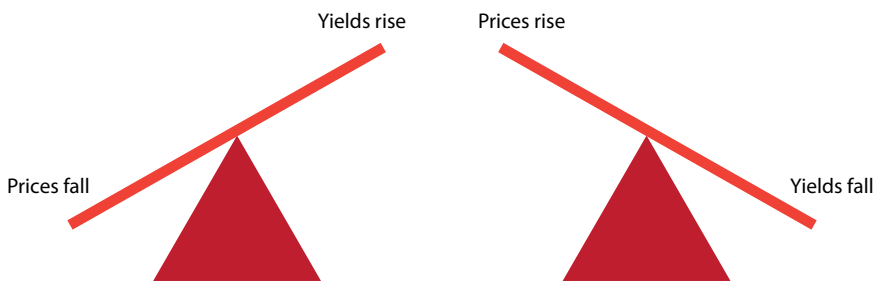
Credit risk – This is the risk of financial loss when the issuer fails to pay the regular interest payments or fails to return the initial capital the maturity date. The risk of default can be high in non-investment grade corporate bonds. Ratings by agencies such as Standard & Poors are supposed to give some idea on the potential for default risk.

Inflation risk – Periods of strong economic growth can lead to rising inflation which erodes the value of the future interest payments on a bond. For this reason, long term bonds in particular tend to be sensitive to changing inflation expectations.

Sovereign risk – It is usual to think of bonds issued by governments to be very low risk. However, sovereign defaults, the risk that a government may not be able to meet its future interest obligations or repay the capital in full at the bond's maturity date, are not uncommon.

Pricing risk – Bonds are not traded on an open centralised exchange like stocks. Instead they are traded on dealer-based over-the-counter markets. Consequently there is less transparency on the value of the bond, its liquidity and the volume being traded. Bond markets are not regulated the same as equity markets.

Illustration 1: Relationship between bonds & interest rates



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