

# A primer on fixed interest investments

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## What are fixed interest investments?

When a company wants to raise money, it can do so in one of two main ways. First of all it can borrow money, either from a bank or by selling bonds or debentures, or by selling shares.

A bond is an IOU. A government, company or other entity that wants to borrow money can go to the bond market and try to sell a contract that specifies an amount of money to be repaid and the size of the interest payments. This IOU, called a bond, a debenture, a note, a bill, or various other names that specify how long the contract is to last and who is selling it, is then able to be bought and sold by interested parties on the market. Generally these things are sold at a fixed interest rate that doesn't change over the life of the contract = hence the term "fixed interest". Each payment, called a "coupon" is paid annually, or quarterly (or whatever, depends on the contract, in fact one type of bond called a "zero coupon" bond doesn't pay you anything at all until maturity).

The word "coupon" has a historic origin from the days when shares used to trade for cash. The bond holder got a bond certificate with a series of little coupons that you cut out and sent to the bond issuer to get your money. These days you no longer have paper bond certificates and you don't have to send in anything to get your payment (this is all tracked by computers now), the term "coupon" still survives and refers to the regular payments. What is the bond market?

The bond market is basically a big auction where people bid to buy and sell bonds, similar to the stock market.

There are new issues of bonds (the "primary" market, and these are sold either by tender (people bid to buy the bond, the price they pay for it indicating what sort of yield they require) or at a fixed issue price determined by the seller.

Once a bond has been sold for the first time on the primary market, the actual bond market where people then trade them is the "secondary market" - same idea as for shares. How do you buy and sell bonds?

You usually go through a bond broker, this may mean you deal face to face with an adviser (a full service broker) who will give advice, or you can buy and sell via a discount broker that gives no advice (but charges less per trade). Many discount brokers have a presence on the Internet and by trading via their automated web sites they can charge even lower rates per trade.

You can subscribe to new offerings, especially government bonds, which are usually sold by the tender method. What drives bond prices?

There is no growth component to bonds, all they do at most is pay you back the face value and your coupons. The biggest influence on bond prices is interest rates, if you buy a bond with a 10% coupon at its offering price, and then interest rates fall from 10% to 5%, the price of your bond will go up, to reflect the higher gain you are getting. With the bond at its new higher price you could sell it and buy a 5% bond and be no better or worse off, basically the price adjusts so the return you get is the same either way.

Of course the converse applies if interest rates go up, you'll make a capital loss.

If you buy a 10% bond and hold it until maturity you'll get 10% plus your money back, all this repricing stuff that occurs with interest rate swings is an effect of the secondary market.

Of course sometimes a bond issuer can't pay back the money and will default on the loan. There are organisations that assess the creditworthiness of various organisations, if they are a high credit risk they will have trouble selling their bonds unless they offer a higher interest rate (why get 5% of Dodgy Bros Inc when you could get 5% off the Government and have essentially no risk at all of default?), so if Dodgy Bros Inc really needs the money they will need to sell their bond for a higher yield, maybe 10% or more. If a company that was reliable runs into difficulties the price of the bonds will fall on the secondary market until the yield becomes attractive enough that a more entrepreneurial investor will want to buy it.

If a company really does fold creditors (who include bond holders) might get only cents in the dollar back on their investment, and maybe not even that. There are specialists that work in the field of "distressed securities" that work out a company's ability to repay their liabilities, from time to time the market underestimates the company's ability to pay back their debts (they might have extra assets that the market is ignoring or mispricing, or their total debts might not be as high as is generally thought). These specialists can sometimes find bonds trading with incredible yields if they reckon that the market's predictions of doom and gloom are exaggerated, the specialist might be able to buy a genuine bargain.

Bonds of risky companies have been nicknamed "junk bonds", if you are a good analyst you may find good value in junk

bonds but unless you are good you had probably best leave junk to the experts and settle for the relatively low yields of government and blue chip corporate debt. Some bond funds specialise in junk, and there is a whole class of hedge fund that gets into distressed securities in general. If you don't think your securities analysis skills are up to it you could invest in one of these funds instead. What kind of return can I expect from fixed interest?

Historically, over the last 50 years or so, bonds have given a return only two or three percent above inflation, so the returns aren't that great. They have no tax rebates or concessions at all and hence if you are going to be taxed on them they aren't a particularly profitable investment. Better returns come from risky bonds (sometimes known as "junk bonds") but these are hardly suited to the sort of conservative investor looking for a reasonably secure income stream.

Bonds are generally suited to conservative investors who need a secure income stream (like pensioners). Growth investors use them for a bit of diversification in their portfolio to keep a bit aside out of harm's way, but bear in mind that after tax and inflation this "safe" investment is usually a long term loss maker. What are the main advantages and disadvantages of fixed interest investments?

First the advantages:

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Generally provide a secure income stream.

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Less volatile than growth assets like shares and real estate.

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If you think interest rates are going down they can be profitable for a short term capital gain, though I will point out that shares and property also go up when interest rates fall, I would generally not advocate the use of bonds for short term speculative use.

And the disadvantages:

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The prices do fluctuate, in particular as a response to interest rate changes. There is a risk of making a capital loss if you have to sell for some reason before the maturity date of the bond. Fluctuations are greatest for longer term bonds, interest rate fluctuations don't cause much of a move in short term debt.

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Low returns, especially the safe government stuff.

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Fully taxed. There are no rebates or concessions at all, you pay tax on all of your profits. When you factor in the low returns above inflation then work out an after-tax profit you won't be too excited by the real returns.