

# understanding bonds

This factsheet is designed to offer a basic understanding of the bond market.

## what is a bond?

A bond is effectively an 'IOU' issued by either a Government or Corporation. By investing in a bond, you are essentially lending money to one of these entities.

In return for the investment, the issuer delivers an agreed level of income in the form of a fixed rate of interest (coupon).

At an agreed date, the Government or Corporation will return the face value (issue price) of the bond, known as the maturity value.

In many ways bonds and shares are constantly in competition for investors' money. When the stock market is falling, investors will often turn to the bond

market for more stable returns. Investing in the bond market can also be an easy way to diversify investments, ultimately reducing the overall risk in a portfolio.

The illustration below demonstrates the lifecycle of a bond as if held from the day of issue.

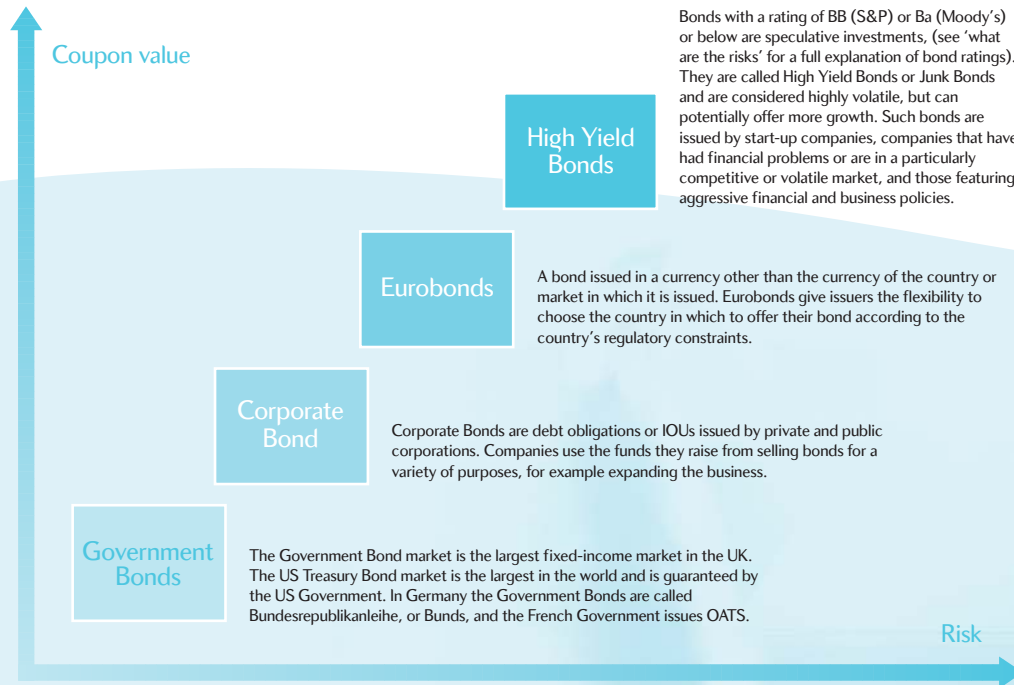


You pay a premium to buy the bond and receive a 'coupon' (the yearly interest payment) in return, for the duration of the bond. The premium is paid back to you at the maturity of the bond.

Bonds can be bought at any time, not just on the day of issue, through the fixed-interest market. In the fixed interest market, the price of a bond may actually be more or less than its original issue price or 'face value'.

# what are the different types of bonds?

There are several types of bonds, each offering different levels of return, with corresponding levels of risk:



# what factors affect the price of bonds?

## Interest rates

Interest rates constantly change in response to supply and demand of credit, fiscal policy, exchange rates, economic conditions, market sentiment and changes in expectations about inflation. As they change, so do bond prices.

- When interest rates rise, new bond issues come to the market with higher yields than older bonds, making those older ones worth less. Hence their price goes down.
- When interest rates decline, new bond issues come to the market with lower yields than older bonds, making those older, higher-yielding ones worth more. Hence their price goes up.



## face value

The value a bond had printed on its face. It represents the amount owed at maturity. On any day before maturity the bond's actual market value may be higher or lower than its face value. When a bond's market price fluctuates it has an impact on its yield. If the price drops below the bond's face value, its yield goes up. If the price rises above face value, the yield goes down.

## yield

The yield (the rate of return on an investment, expressed as a percentage) is obtained by dividing the current market price of the bond into the annual interest payment. As a price of a bond declines its yield rises. Let's look at a bond issued with a 4% yield. If you were to buy \$1,000 worth at launch, you would receive \$40 in the first year ( $\$40/\$1,000 = 4\%$ ). But if the price drops to \$800, the yield rises to 5%. Why? Because the guaranteed coupon - \$40 - is now 5% of the \$800 paid for the bond ( $\$40/\$800$ ). If the price rises to \$1,200, the percentage shifts down to 3.33%.

## Inflation

The interest rate paid to bondholders is fixed at a rate determined on issue. Consequently, if inflation rises, the 'income' received from the bond actually becomes worth less, as goods and services become more expensive.

Inflation is one of the most influential forces on interest rates. Rising inflation often leads to rising interest rates, which reduce bond prices. Conversely, deflation would result in a lowering of interest rates, which would increase the price of bonds.

## what are the risks?

Whilst bonds have a reputation for being conservative investments, there are still elements of risk that you should be aware of in addition to interest rates and inflation expectations.

Credit risk is the potential for loss resulting from a decrease in the financial health of the issuing company. Most corporate bonds are evaluated for credit quality by companies who provide financial market intelligence, such as Standard & Poor's and Moody's Investors Service. Bonds rated BBB or higher by Standard & Poor's and Baa or higher by Moody's are widely considered 'investment grade'. This means the quality of the securities is high enough for a cautious investor.

'Non investment grade' bonds, those rated BB or lower by Standard & Poor's or Ba or lower by Moody's, are deemed to carry a higher 'default risk'. Default risk is the risk of non-payment of the bond's coupon or failure to repay the

bond's face value at maturity. This scenario would usually be as a result of the issuing company going bankrupt.

Returns on corporate bonds are higher than Government bonds. This reflects that there is a risk of companies going bankrupt and being unable to repay the bonds or meet yield payments whereas Governments rarely default on their interest payments. In short, company bonds pay more to reflect the higher risk of these investments against Government bonds.

Inflation risk, interest-rate risk and credit risk all play a part in the pricing of bonds - the more risk, the higher the yield. It's also true that investors demand higher yields for longer maturities. The reason for that is obvious - given enough time, a once healthy corporation can go bankrupt and suddenly lose the ability to pay its obligations. Alternatively inflation could run rampant, seriously eroding the purchasing power of the amount an investor gets back in ten years.

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## why invest in bonds?

The complexities of yields and credit ratings can easily detract from the key benefits associated with bonds, such as capital growth and a fixed 'income' stream. Moreover, bond returns are not highly correlated with those of equities. In other words, if equity prices fall bonds will not always follow suit and usually rise. For this reason, when combined with other asset classes they can be a useful diversification tool.

**A financial adviser will be able to offer further advice about bonds and whether they are a suitable investment for your needs.**

Where the running yield (an estimate of the income return) of a bond fund is greater than the redemption yield (the total return if all the bonds in a fund were held to maturity) this may signify an erosion of capital.

Yields are not guaranteed and may rise and fall.

This factsheet sets out the basics of the bond market. It is not designed to be investment advice and should not be interpreted as such. Other factors may need to be taken into account before making an investment decision. Your financial adviser will be able to offer you advice on this.

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