Global Asset Management

Bond Basics: A Primer

Investing in bonds or bond funds can often involve a lot of investment jargon. In this primer, we endeavor to demystify the complexities of bond investing by touching on the key aspects of this important asset class.

What is a bond?

A bond is a financial instrument that allows a government or corporation to borrow money from investors. It is typically issued at a set rate of interest over a specific period of time – from the date the bond is issued to its maturity date. The interest rate (or coupon) that is paid for this loan is determined by a variety of factors, such as the creditworthiness of the issuer and the prevailing rate of interest offered in the market at that point in time.

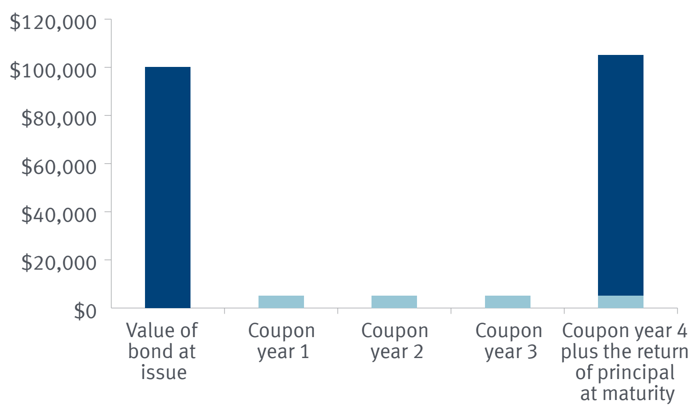
Bonds issued by governments typically pay a lower rate of interest than corporations because there is a lower risk that they will be unable to pay back the loan. For the purposes of this primer, we will focus on government bonds and the factors that influence them.

Provided you buy a bond for the same price as its principal value, your investment return will be the value of the coupon payments you received, assuming the original amount is returned to you in full. If you decide to sell your bond in the market prior to its maturity date you may also have a gain or loss based on whether the bond was worth more or less than the principal value.

What is a bond's yield?

Earlier we mentioned that a bond pays a periodic interest payment or coupon, which is typically a percent relative to a bond's principal value. This can also be referred to as the bond's yield-to-maturity. In the illustration above, the bond's coupon or yield is 5.0%. Assuming a bond is issued at $100,000 – what is referred to as par – the coupon rate and yield will roughly be the same: 5.0%.

A four-year bond with a 5% annual coupon



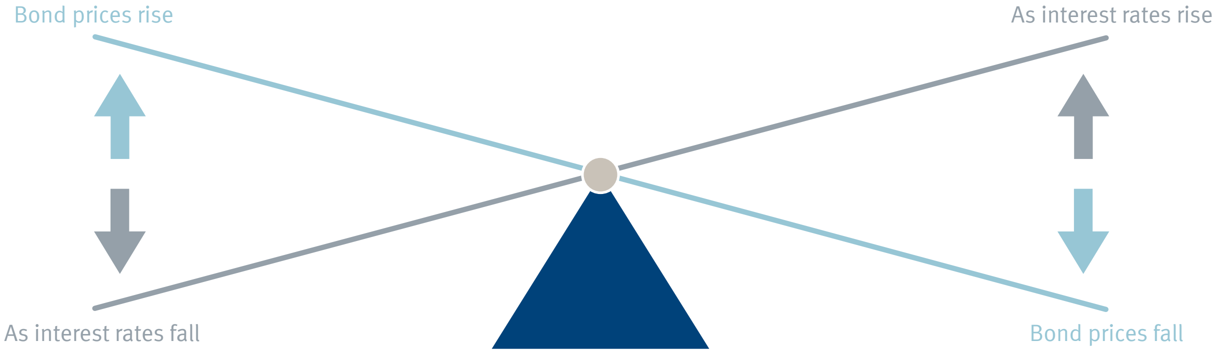
Provided you hold the bond to the maturity date and reinvest the coupons at the same rate of interest, the yield will also be a good indication of your annual investment return for that period.

What factors influence bond yields?

A bond's yield is also a reflection of the current market rate for bonds – how much investors demand for lending money to an issuer for a specified period of time. The longer the holding period, or term-to-maturity, the more you need to be compensated for having your money tied up.

There are a number of factors that can influence bond yields, including macro-economic developments. As an example, when inflation was high in the early 1980s, bond yields were high too. In September of 1981, the yield on a 30-year Government of Canada (GoC) bond would have been around 18.0% while inflation that year averaged 12.5%. Today, the yield on a 30-year GoC bond is closer to 2.3%.

Bond prices and interest rates generally move in opposite directions



If Canada's economic picture continues to improve and inflation moves higher, we can expect that the yield on our GoC bond will go up. Since the bond in our earlier illustration was issued prior to bond yields going up, our bond needs to fall in price (as shown in the above chart) to reflect this higher rate of interest. In a rising rate environment, the coupons you receive on your bond will now be reinvested at a higher yield.

What is duration?

Another term that is often discussed in the context of bonds is duration. Duration allows investors to see how sensitive a bond is to changes in interest rates. For example, if a bond has a four-year duration it would either rise or fall in price 4.0% for every 1.0% change in yield. The further away that bond is from its maturity date the longer its duration and the greater the price change for any given change in yield. Remember that even though your bond will fall in price at the time rates rise, you will be reinvesting your coupons at this new higher rate. Over the term of your investment, that higher reinvestment rate will help offset the initial fall in the bond's price.

Although it may be unsettling to see negative rates of return in bonds when yields are rising, having an adequate time horizon and reinvesting at higher rates can be beneficial to overall fixed income returns.

Why is it important to consider bonds as part of your portfolio?

Holding bonds in your portfolio can offer a number of benefits, such as providing a predictable source of income and helping to preserve capital as bond returns tend to be less volatile than equities. In an actively managed bond fund you also have the opportunity to earn capital gains when bonds are bought and then sold, by the fund manager, at higher prices. Ultimately, bonds provide attractive diversification benefits to your portfolio as they tend not to move in the same direction as other asset classes.

For more investment insights, please visit www.rbcgam.com or talk to your financial advisor.

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