

Fixed Income

The recent market volatility has proven the importance of diversification, not only of manager investment styles but also in asset classes. Investors seeking income or a higher rate of interest than that from Government bonds and deposit accounts have increasingly turned to corporate bonds. Bonds are considered a more defensive asset class since their price movements change less in response to economic stimuli than those of equities. However, this also means they do not offer the same potential for long-term performance.

What is a Bond?

Bonds are 'IOUs' with a specified rate of interest. The bond provider, or borrower, undertakes to pay the purchaser of the bond interest on a regular basis until maturity. The interest is known as the coupon. As well as interest, the provider or borrower has to repay the initial purchase price, or principal. This is normally due at maturity. Interest can be a fixed percentage, vary in line with interest rates or be linked to inflation or an index. It is set when the bond is issued.

What is the relationship between interest rates and bond prices?

There is an inverse relationship between interest rates and bond prices, which means that:

- as interest rates rise, the price of a bond will tend to fall and the yield increases;
- as interest rates fall, the price of a bond will tend to rise, reducing the yield

If interest rates rise and exceed the return of bonds, then bondholders are likely to sell their bonds in order to invest into cash for the better return. Bond prices will fall until they reach a level at which the yield becomes attractive again for investors.

How are Bonds shown in publications?

Bonds are usually denoted by their coupon rate and maturity. Let's use an example of a £100 bond provided by the Treasury, which pays a coupon of 6% until 10 June 2010. The holder of this bond can expect to receive an interest payment of £6 every year (6% of £100). These will continue until 10 June 2010, the maturity date, at which time the bondholder will receive both the coupon due, £6, and the principal, £100. In fund holdings sections of fact-sheets this would be shown as UK Treasury 6% 10/06/10. Some bonds may have more than one maturity date, e.g. UK Treasury 6% 2007-09, where the debt may be repaid within any one of three years - 2007, 2008 or 2009.

What are Gilts?

A gilt is a bond from the UK Government. Gilts got their name from the gilt-edged paper on which they were historically printed and are usually called after the part of the Government that has issued and backed them. Since the UK Government is unlikely to go bust gilts are considered to be free of default (non-payment) risk.

Conventional gilts, more commonly just referred to as gilts, are the simplest form of Government bond. They pay a fixed rate of interest. This is paid every six months, on a fixed date, until maturity. At maturity the holder receives the final coupon payment and the return of the principal. The prices of conventional gilts are quoted in terms of £100 nominal but can be traded in units as small as a penny. The coupon rate usually reflects the market interest rate at the time of the first issue of the gilt so there is a wide range available.

Gilts can be further subdivided into **dated gilts** with a stated maturity date and **undated gilts** with no maturity date. Undated gilts pay a fixed level of interest every year, indefinitely.

A gilt can be broken down into different tradable parts known as 'Gilt STRIPS'. STRIPS is the acronym for Separate Trading of Registered Interest and Principal Securities.

What are Treasury Bills?

Treasury bills, or T-bills, are issued by the Government to cover short-term liquidity shortfalls. They can be issued for a period of up to a year but tend to be issued for approximately 90 days. T-bills are often used in money market and cash funds.

How do Index-linked Gilts differ from Conventional Gilts?

Index-linked gilts (ILGs) have interest payments and principal repayment amounts linked to an index to compensate the investor for any rise in inflation. Coupon payments and the principal are adjusted in line with the UK Retail Prices Index (RPI) so that the holder is protected from inflation during the term of the ILG.

What are Corporate Bonds?

Companies, rather than the Government, issue corporate bonds. They are a way to raise money for projects and investment and are also known as credit. There are two main subdivisions of corporate bonds depending on their credit rating;

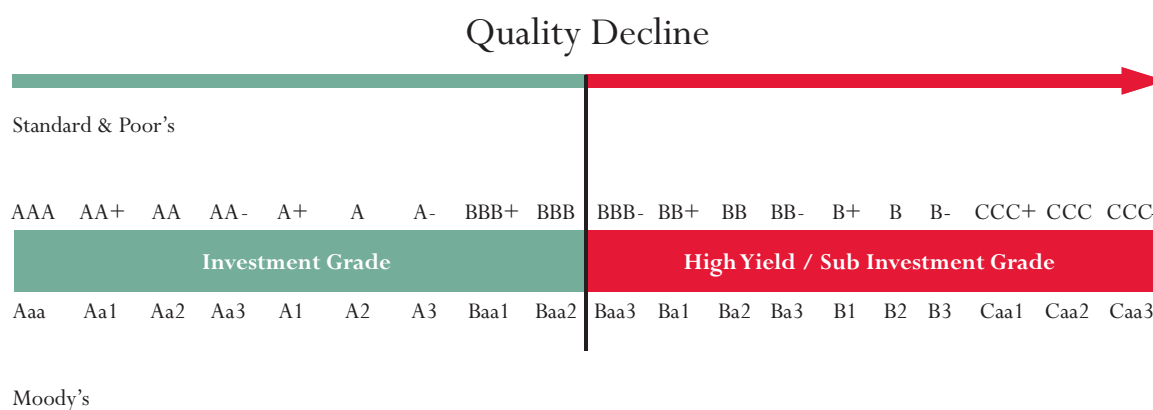
- investment grade
- sub-investment grade (also known as high-yielding bonds or 'junk' bonds)

How are Corporate Bonds rated and by whom?

Independent ratings agencies are responsible for researching companies and supplying 'grades' or 'ratings' to companies' debt (bond issues). Two of the most well known ratings agencies are Standard & Poor's and Moody's.

With investment grade bonds it is assumed that the chance of non-repayment or default is low due to the issuing company having a comparatively stable financial position. Typically, over the course of a five-year cycle, fewer than 0.5% of investment-grade bonds default.

High yielding, sub-investment grade bonds are higher risk investments. These tend to be issued by companies without long track records of sales and earnings or companies with questionable financial strength. The default rate of these bonds is expected to be higher than investment grade corporate bonds, at least 4.0% over the course of a five-year cycle. Rating high-yielding bonds is more difficult and consequently different agencies will often provide different 'grades' as well as denoting grades differently as below:



What other sub-divisions of corporate bonds are there?

Corporate bonds can be further subdivided into secured or unsecured:

- Secured bonds are backed directly by the company's assets, in the same way that your mortgage is backed by your property. Returns are generally lower to reflect the more secure nature of the bond.
- Unsecured bonds are not backed by specific assets and are therefore only as safe as the issuer since no particular asset has been 'set aside' as a guarantee of repayment.

Senior and subordinated debt are also possible subdivisions;

- Senior debt holders have preferential claim on a company's assets in event of a default. In the event of a company being liquidated repayment to creditors is as follows: senior secured, junior secured, senior unsecured and finally subordinated. Senior debt holders will pay for this 'liquidation priority' through comparatively higher prices or lower returns than from subordinated debt.

What are Convertible Bonds?

Convertible bonds are a hybrid between bonds and equities, giving holders the right to convert their bonds into shares in the company issuing the bond at a specified date or dates in the future.

Is the UK the only market for bonds?

The UK bond market is relatively small in global terms. The biggest bond market by far is the United States, where companies have long relied upon corporate bond markets as a means of finance, rather than bank borrowing. For a UK investor, overseas bonds have an added risk: currency fluctuations. If the pound strengthens against the bond's currency, the investor will see their returns reduced, conversely if the pound depreciates, the investor's return is boosted.

Bonds are said to have yields. What are they?

There are typically two yields to indicate the return the bond provides to an investor:

1. Income Yield, also called the **interest yield** or **running yield**, is a simple measure of how much annual income a bond will provide to the investor. It is simply the coupon divided by the market price paid by the investor. For example, an investor buys UK Treasury 6% 10/06/10 at a price of £103. Although 6%, the income yield is shown below;

$$\frac{\text{Coupon}}{\text{Price}} = \frac{\pounds 6.00}{\pounds 103} = 5.83\%$$

It has to be borne in mind however that on 10 June 2010 the investor will only receive £100 on redemption for an investment that cost £103.

2. Redemption Yield - takes account of both the income received until maturity and the capital gain or loss you would make when that date arrives, i.e. the total return. If a bond is purchased for more than its redemption value, the capital loss at redemption means the redemption yield will be less than the income yield.

$$\frac{(\text{Remaining Income} - \text{Capital loss}) / \text{Coupons to maturity}}{\text{Price}} = \frac{(\pounds 15 - \pounds 3) / 2.5}{\pounds 103} = 4.66\%$$

Depending on market conditions, there can be a substantial difference between the redemption yield and the income yield.

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