BONDS 101

by Tom Downes, Performance and Marketing Analyst, BTS Asset Management, Inc.

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Find Opportunity

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When you hear the word “investing”, the stock market is probably the first thing that comes to mind. Stocks are exciting, and they are often discussed in the news and at cocktail parties. Bonds, on the other hand, may be less thrilling, are much less publicized, and are often viewed as a drag on a portfolio, especially in a raging bull market. However, all it takes is one bear market to remind investors of the importance of bonds, and the safety and stability they can provide. For most investors, bonds are an essential piece of a portfolio.

What are Bonds?

Have you ever taken out a loan or even borrowed money from a friend? Then you already understand the basics of a bond. Just as an individual may need to borrow money to purchase a home or a car, corporations and governments rely on loans to fund their operations. The difference is, large organizations require large amounts of funds, typically far more than could be provided by the average bank. The solution is to essentially crowdsource these loans by issuing bonds to a public market. Thousands of investors then each lend a portion of the capital needed, with an agreement in place that they will be repaid at some future date. Furthermore, the lenders (investors) of these bonds don’t want to give out their hard-earned money for nothing, which is why the borrower (issuer) provides incentive in the form of interest (or coupon) payments, which are made at a predetermined rate and schedule. The date on which the issuer must repay the full amount of the loan (the face value), is known as the maturity date and may range from 3 months to 30 years.

Why Buy Bonds?

Bonds provide several advantages over stocks and other investment vehicles, making them beneficial to nearly all portfolios. For investors facing particular financial circumstances, bonds are even more crucial. Here we will take a look at the reasons any investor should consider bonds, and then the types of investors to whom bonds are indispensable:

- **Advantages of Bonds**
  - Capital Preservation – Because a bond issuer must pay back the face value of the bond at maturity, the investor’s original principal is preserved. The degree of preservation varies with bonds of different types and ratings. For example, a U.S. Government bond essentially guarantees repayment, whereas a low-quality corporate bond has some risk of default (failure to repay the full principal). This risk of default is compensated for with a higher coupon payment. This reasonable assurance of capital preservation stands in stark contrast to purchasing a stock, where the value of your investment could be reduced all the way to zero.
  - Fixed Income – Many investors require steady cash income, which is exactly what bonds provide with their fixed, regular interest payments. Stocks may provide income through dividend payments, but dividends tend to be smaller than bond coupon payments, and companies pay dividends at their discretion, whereas bond issuers are obligated to make their coupon payments.
  - Capital Appreciation – Just like a stock, bonds trade in secondary markets and face price fluctuations. The price of a bond tends to rise when interest rates drop, or when the credit standing of the issuer improves. Conversely, the price of a bond tends to fall when interest rates go up. If you hold the bond until maturity, you will receive only the principal plus interest payments along the way, however if you sell the bond after it has risen in price – and before maturity – you can realize price appreciation. The combination of price appreciation and fixed interest payments is known as total return.
  - Diversification – Including bonds in a portfolio can help diversify the portfolio, which reduces market risk, or the risk that your investment will fall in value as the overall market falls. Compared to stocks, bonds are much more certain in nature and they hold up much better in tumultuous markets. Without this buoying effect of bonds, your portfolio could be in big trouble when there is a major sell off in the stock market.
- **Who Needs Bonds?**
  - Anyone who can’t tolerate the short-term volatility of the stock market, particularly:
    - Retirees – An investor who is retired and living off a fixed income simply cannot afford to lose their principal as it is required to pay the bills.
    - Short-horizon investors – Its not just retirees that require the safety and stability of bonds. Consider a young investor who plans to purchase a home in three years. They have saved the money required for a down payment, but they don’t want these funds to sit in a savings account for three years, earning them next-to-nothing. On the other hand, the investor cannot take the chance of losing their money in the short-term, which is an inherent risk of the stock market. Bonds are likely the best investment.

What Determines the Coupon Rate of a Bond?

Remember that the coupon payments of a bond are the interest that an investor receives for lending their money to a government or a corporation. But how is the coupon rate determined? In the simplest terms, the coupon rate is established by the issuer at the time of issuance. However, several factors affect the attractiveness of these offers to investors, and thus the prevailing coupon rates in the markets. The first and most powerful factor is the level of interest rates prevalent in the economy. Higher market interest rates lead to higher bond coupon rates. But not all bonds are created equal, and the level of risk associated with a particular bond, indicated by its credit quality and structure, must also be reflected in its coupon rate. An investor purchasing a low-quality corporate bond will demand a higher coupon than an otherwise similar high-quality corporate bond, because the low-quality bond has a higher risk of default. Furthermore, an investor purchasing a U.S. Government bond will accept an even lower coupon rate, due to the assurance that they will receive their full principal on the maturity date. Another factor is the length of the bond's maturity, with longer-term bonds typically paying higher coupon rates than shorter maturities.

What Affects the Value of a Bond?

If you buy a bond from a corporation or a government with the intention of holding it until maturity, you don't need to fret over the price movements of the bond. Regardless of any fluctuations, you will receive the full face value on the maturity date. But what if a bond investor plans to capitalize on price movements by trading bonds and realizing gains on price appreciation? Then it is important to understand the main factors driving bond prices. These are interest rate movements, credit quality, length to maturity, and supply and demand factors.

- Interest Rate Movements – This is the most important factor of bond price movements. When market interest rates fall, the prices of bonds rise, and vice versa. The reason for this is best illustrated through an example. Let's say that one year ago you purchased a bond of ABC Company, which pays you a 3% annual coupon. Now, one year later, market conditions have changed and new bonds similar to yours are paying only a 2% coupon. Now, other buyers in the market would prefer to buy your bond which pays 3%, compared to the new bonds that only pay 2%. Thus, they would be willing to pay a premium for your bond, and if you agree to sell you would have a gain on your original purchase.

- Credit Quality – Similar to how individual borrowers are assigned a credit score, a bond issuer is evaluated for credit risk based on their financial performance and the likelihood that they will be able to meet future debt obligations. For a new bond issue, the credit quality determines the coupon rate. However, when an issuer with outstanding bonds sees a change in their credit quality, the price of those bonds will be affected. An upgrade in credit quality will increase the value of the bonds and a downgrade will lower them. U.S. Government bonds are not rated for credit quality because they are considered to be free of credit risk.

- Length to Maturity – Remember that interest rates have an inverse relationship with bond prices. Given a change in interest rates, bonds with longer maturities will tend to have larger price fluctuations compared to shorter maturity bonds.

- Supply and Demand Factors – As with any investment trading in an open market, bond prices are affected by supply and demand. At any point in time a bond's price could increase or decrease based on excess supply or demand factors for that particular bond or the type of bond.

What are the Risks Associated with Bond Investing?

As with any type of financial investment, bonds carry some degree of risk. It is important to consider your personal risk tolerance when developing a portfolio strategy. Here are a few of the main risk factors to consider:

- Credit Risk – Also known as default risk, this is the risk that the issuer won't be able to make timely principal and interest payments. The U.S. Government is considered to have the least credit risk of all bond issuers, essentially ensuring timely payments. Corporate bonds carry greater credit risk and are assigned a credit quality by one of the two major credit rating agencies. The two broad categories of credit quality are "Investment Grade" bonds, which have only a modest likelihood of default, and "High Yield", whose issuers have more uncertainty in their ability to make principal and interest payments.

- Interest Rate Risk – This is the risk that rising interest rates will cause a bond to lose value. The degree of interest rate risk depends on many factors such as credit risk, time to maturity, coupon rate, and supply and demand. Bonds with shorter maturities and higher coupon rates tend to have more price stability in periods of rising interest rates.

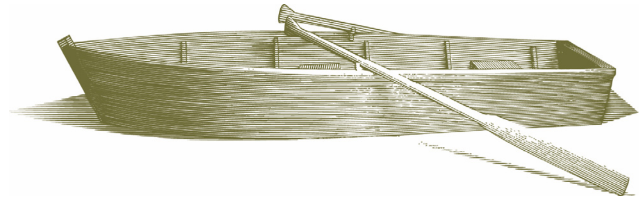
- Marketability Risk – You may want to sell a bond before its maturity date, however for certain classes of bond it may be more difficult to find a buyer. Any potential lack of marketability should be considered.

- Call Risk – Certain types of bonds may be callable, meaning that the issuer can redeem the bond before the original maturity date. If you were planning on holding the bond to maturity and collecting the fixed payment along the way, this could be undesirable. Furthermore, issuers typically choose to call a bond when interest rates are falling, so if you choose to reinvest the proceeds, it will likely be at a lower rate.

- Inflation Risk – This is the risk that inflation will negatively impact the purchasing power of a bond's principal and interest payments.

- Reinvestment Risk –Let's say you prefer to take your coupon payments and reinvestment them into the market. If market interest rates are falling, your rate of return on these reinvested coupons will be diminished.

Now that you know the basics of bonds, it's time to consider adding them to your portfolio. This guide focused on basic U.S. Government bonds and corporate bonds, but it's important to remember that there are many types of bonds that may offer features related to tax planning, inflation hedging, and others. Thus, it is always prudent to speak with a financial professional to help guide you through the bond markets based on your personal goals and investment objectives.



Each of these asset classes has its own set of investment characteristics and risk and investors should consider these risks carefully prior to making any investment decisions.

Past performance is no guarantee of future results. Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

The value of the fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower-quality bonds known as “high yield” or “junk” bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds.

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About BTS Asset Management

Founded in 1979, BTS Asset Management is one of the oldest risk managers, managing traditional assets with a nontraditional approach. BTS has a multi-year track record in tactical fixed income and equity management. Our goal is to find opportunities with the potential to take advantage of rising markets while working to manage losses during downturns.

BTS:

- Seeks to preserve capital
- Aims to offer downside protection and upside potential
- Strives to reduce volatility while delivering consistent long-term returns

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