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Accounting|Financial Planning

Beginner's guide to bonds

Fact sheet Fact sheet Fact Sheet Fact sheet Fact sheet

When interest rates are low, people who depend on income from their investments are constantly on the lookout for ways to spice up their investment returns without veering into risky territory. If that sounds like you, it may be worth considering bonds. They might sound boring, but bonds are gaining popularity among everyday investors for their ability to weather financial storms. Bond returns are not stratospheric but they can be reliable and deliver regular income into your account. What's more, the forces that drive shares down are usually the same that prop up bonds, making them a handy way to diversify your investment portfolio.

What are bonds?

Bonds are a type of debt – a type of glorified term deposit. Companies and governments borrow money from you, the lender, and make regular interest payments, called a coupon, for the life of the bond.

There are many types of bonds, such as fixed rate, floating rate, inflation- linked and hybrids. They can be issued over three, five or 10 years and some as long as 30 years.

Bellwether bonds

Bonds are an excellent bellwether for the global economy. Their popularity tends to increase when economic times are tough and interest rates are low as they are now. It may sound counter-intuitive, but the price of bonds rise when interest rates go down. Conversely, an interest rate hike can cut the value of your bond investments. The price movement depends on the size of the interest rate change and how long the bond has to run before it matures.

Fix, floating and inflation-linked

Bond interest rates are either fixed or floating. The interest on fixed rate bonds remains the same over the life of the bond. Floating rates change depending on market rates and inflation-linked bonds are tied to the rate of inflation. Despite most economists predicting a rise in long-term interest rates, which would mean a fall in bond prices, incorporating a variety of bonds in your investment portfolio remains a solid strategy for protecting your cash flow from interest rate fluctuations.

Government bonds

Australian government bonds are regarded as risk-free and are used as the benchmark to measure risk in other asset classes. They are an ideal defensive asset and offer reliable returns.

Federal and state governments issue government and semi-government bonds respectively for medium to long-term investors.

Corporate bonds

Companies issue corporate bonds and other types of fixed-interest securities. Investors need to be mindful of a company's credit rating and where the bond resides in the debt hierarchy should a company collapse.

Despite offering better returns than their government counterparts, corporate bonds are also higher risk.

continued on next page

Fact sheet Fact sheet Fact Sheet Fact sheet Fact sheet

continued from previous page

Hybrids

Hybrid securities are bonds with extra pizzazz. Like bonds, they pay a fixed or floating interest rate until a set date. Yet part of their appeal is the potential to convert them into the issuing company's shares.

Hybrids offer investors higher interest rates and the potential for higher capital gains (and losses) than government bonds. In terms of the trade-off between risk and return, they are closer to shares than bonds.

Buying bonds

Bonds can be bought upon issue and held until maturity or they can be bought and sold on the secondary market, offering the opportunity to make capital gains (or losses). Some are listed on the Australian Stock Exchange while others are traded via a broker.

However, the minimum purchase amount can be high when buying bonds direct. Professionally-managed bond funds are generally an easier way for private investors to expand their bond holdings.

The choice of bonds available to individual investors has grown enormously since the global financial crisis with access opening up to government bond, index, actively- managed and diversified bond funds. However, the complexity of the bond market means professional advice is recommended in order to select the right mix of bond investments for your future income needs.

Contact us

If you would like to discuss bond investments within the context of your overall portfolio, please contact us:

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