Module 1
Why invest in bonds?

ASX

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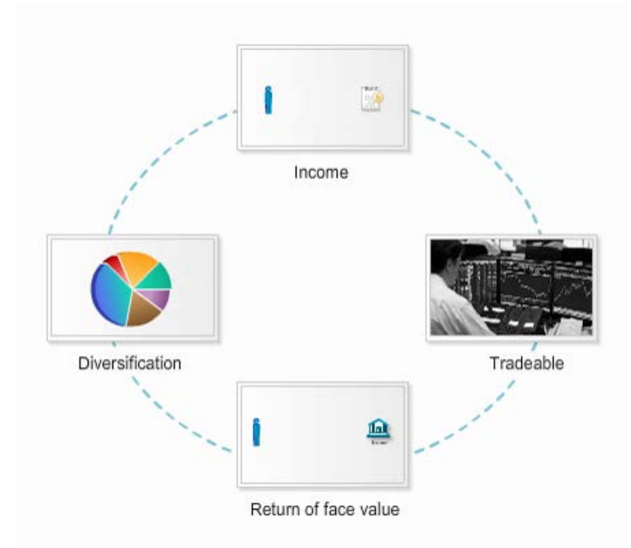
Topic 1: What's to like about bonds



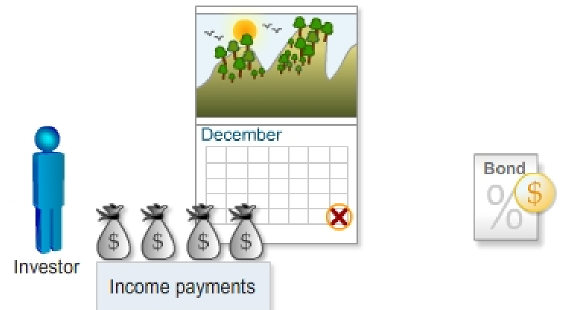
Bonds appeal to investors looking for a regular and reliable income stream.

Bonds quoted on ASX:

- offer to pay a defined income stream
- offer to return their face value at maturity
- enable you to diversify your investments
- can be bought and sold through your ASX broker.

The focus of this course is corporate bonds - we have a separate course on Australian Government Bonds.

Defined income



Why invest in bonds? To receive regular income.

Your income may be paid once, twice or four times a year.

Income from bonds is typically higher than interest paid on bank deposits.

Return face value

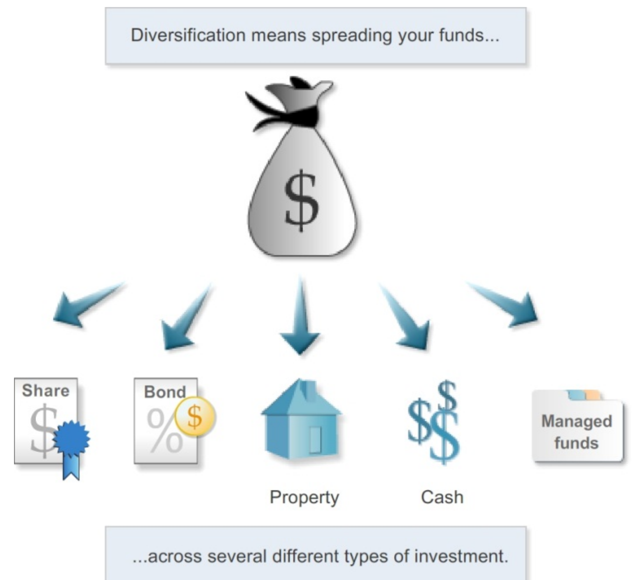
At the end of the investment's term
Face value is returned

Bonds are issued with a fixed date at which they mature.

At their maturity, the issuer of the bond promises to pay the face value of the bond to the holder. The holder is whoever owns the bond at that time.

(Face value is the amount the bond was originally issued for, usually $100.)

Diversification



Diversification is fundamental to wise investing. You can reduce your overall risk by spreading your funds across several asset classes, and across different investments within each class. Bonds are a member of the 'fixed interest' or 'interest rate' asset class. Shares are a member of the equities asset class.

Bonds are quoted on ASX, but this doesn't imply that their performance is the same or correlated with shares. They may hold their value when share prices are falling, while at other times shares may outperform bonds.

Traded, cleared and settled on ASX

You buy and sell bonds quoted on ASX through your ASX broker, just as you buy and sell shares.

This makes it simple to buy or sell at short notice. Compare this to a term deposit held at a bank, where you are locked in for a fixed period of time. Ensuring that your bond is quoted on ASX means you are dealing on-exchange, not over-the-counter. Bonds traded on ASX provide investors with transparency, liquidity and security in terms of the bond's safe keeping, settlement and clearing.

Topic 2: How do they work?

How bonds work

When a company needs to raise money they can borrow from investors by issuing bonds.

Investors who purchase a bond from an issuer are lending them money for a fixed period of time.

In return for this loan, bond holders typically receive:

1. defined interest payments at regular periods

2. payment of the bond's face value at maturity.

Corporate bonds quoted on ASX can be bought and sold at their current market price during ASX trading hours.

Hybrid securities combine features of shares and corporate bonds. Types of hybrids include preference shares or convertible notes. While they do share some features of bonds, they have their own unique benefits and risks. We have a separate course on hybrids.

The holder of the bond receives defined income and the repayment of face value.
If the investor sells the bond on ASX the buyer becomes eligible for the income and the repayment of face value.

Bond features

While all bonds share the same core structure - (being a loan from one party to another with the promise of interest payments and return of face value at maturity) - there are variations in some features. These differences can be broadly grouped under:

1. Type of interest:

- fixed,
- floating or
- indexed.

2. Type of issuer:

- government or
- corporate.

Bond features	
Secured/Unsubordinated	Level of risk
Fixed/Floating/Indexed	Type of interest
Corporate/Government	Type of issuer

3. Level of risk:

- secured (there is an asset backing the debt)
- unsubordinated (not secured by an asset but rank ahead of unsecured creditors).

Let's look at these in detail.

Interest rates - fixed, floating and indexed

Interest rates	Fixed rate payments	Floating rate payments
▲	unchanged	up
▼	unchanged	down

Fixed rate bonds pay a set rate of interest for the life of the bond. This rate is known as the coupon rate. These bonds promise to pay the same amount every payment date.

Floating rate bonds have their payments linked to a short term benchmark interest rate - their payments 'float' in line with changes to these short term interest rates in the market.

This type of bond is generally called a "Floating Rate Note".

Index bonds are generally only associated with government bonds and have their payments linked to changes in inflation (reminder - we have a separate course on Australian Government Bonds).

We look at fixed and floating rates in more detail in Module 2.

Bond issuers - corporates vs. government

Bonds issued by the Federal Government have a lower credit risk than corporate bonds. Their low risk implies very secure cash flows, but also means relatively low yields to maturity (we explain this term in detail in Module 2).

Bonds issued by companies can vary significantly in their risks. If the issuer is considered a higher risk (less credit worthy), investors will expect a higher yield to compensate for that risk. Most bonds have assigned to them a credit rating which can assist you in understanding the credit risk of the issuer and complexity of the bond.

Level of risk

Investors are sometimes lax in understanding exactly what risk they are accepting when making an investment - until things go badly and by then it can be too late.

The product description in a bond's prospectus will give you information on the type of risk you are accepting.

- "Secured" - generally means there is an asset that can be sold to pay back bond holders in the event of financial trouble (this is not a guarantee though).
- "Unsubordinated" - generally means bond holders rank behind secured creditors but ahead of unsecured creditors for any assets that are liquidated in the event of the business being wound up.
- "Subordinated to debts to unsecured creditors" - debt ranks behind unsecured creditors. Generally ASX does not permit such heavily subordinated securities to be called bonds.

Why isn't debt that is subordinated to unsecured creditors called a bond? Because it is too similar to equity capital. The next two screens explain the distinction between equity capital and debt capital.

Equity capital vs. debt capital

A shareholder has equity capital in a company. Their shares represent part ownership of a company.

Equity capital	Debt capital
Shareholder	Lends money to company
Owns part of company	Creditor

A bond holder is someone who lends money to a company - this is debt capital. A bond holder is a creditor - owed money by the company, not owning part of it.

Securities called bonds sit entirely in the category of debt capital. Securities that might look like bonds but have other names, i.e. convertible notes, preference shares, hybrids, etc... sit in equity capital.

Equity capital vs. debt capital - why it matters

Why does the distinction between equity and debt matter?

Shareholders and creditors are treated differently when it comes to the payment of income, and if the company goes into liquidation.

The payment of interest to creditors/bond holders has priority over the payment of dividends to shareholders.

Secondly, the repayment of debt ranks before payments to shareholders if the company is wound up.

When times are good, this may not be an issue, but if a company gets into financial trouble this can make a big difference to the performance of your investment.

	Shareholders	Creditors
Payment of interest/dividends	Lower ranking	Higher ranking
Repayment of capital	Lower ranking	Higher ranking

Topic 3: Not the same as shares

Bonds and shares are different

Just because bonds can be bought and sold like shares and they are issued by the same companies that you can trade shares in, does not mean they are the same sort of investment.

Bonds need a different investment assessment framework than you would use for share selection.

Working through this course is an essential part of building your knowledge before making any investment in bonds.

Let's review the main differences between shares and bonds.

Higher face value

Bonds typically have a higher face value than shares.

Most bonds are issued with a face value of $100.

Limited life

Bonds have a maturity date, at which point either repayment of face value takes place. Shares, by contrast, have an unlimited life.

Capital growth potential

The return from bonds is primarily in the form of income. The potential for capital growth is generally a secondary consideration.

As maturity nears, the price of a bond tends to approach face value.

Non-standardised

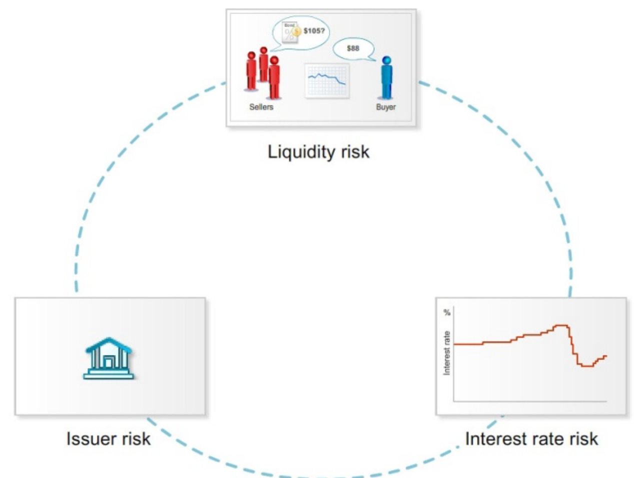
The concept of a fully paid 'ordinary share' means the same thing regardless of the company you invest in.

Bonds are not standardised. Each bond has different characteristics such as maturity date and level of income paid.

It is essential to become familiar with the details of any bond you are considering investing in by reading the prospectus.

Topic 4: Things to look out for

Like all investments, bonds involve risk.



The main risks are that:

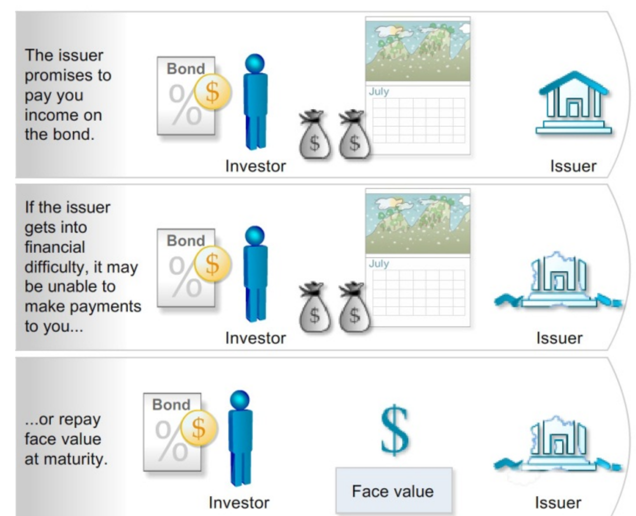
- the company will be unable to pay the promised income distributions, or repay the face value at maturity (issuer risk)
- your income will be affected by an unfavourable movement in market interest rates (interest rate risk)
- you may not be able to sell your bonds for a fair price (liquidity risk).

Let's look at these risks in more detail.

Issuer risk

You rely on the company that issued the securities to:

- pay the promised distributions, and
- repay the face value of the securities at maturity.



It is essential to consider the company's creditworthiness when researching an investment in bonds. If the company is unable to make an interest payment(s) on your investment, your income will be lower than expected.

If the company goes into liquidation, you may not get all (or any) of your money back.

Interest rate risk

Interest rate risk is one of the hardest concepts for new bond investors to understand.

Movements in market interest rates can negatively affect bonds you own.

	Fixed rate bond	Floating rate bond
Income payment	Unchanged	Increases
Market price of bond	May fall	Unaffected

If your bonds pay a fixed rate of interest, an increase in market interest rates can mean:

- you may receive less income than is available from other investments offering the higher market rates, and

- your bonds may trade at a lower market price, as other investors will find them less attractive than investments that pay higher interest.

If your bonds pay a floating rate, as rates rise, the income you receive will also increase. However, as rates fall your income will decrease.

Risk of being unable to sell your bonds (liquidity risk)

If you want to sell your bond before maturity, you do this on market.

Liquidity risk is the risk that you may not be able to sell your bond for a fair price.

There may be insufficient orders to buy or the price offered may be too low. This is generally only a problem for bonds where there are not many buyers and sellers active in the market for them.

It is easy to check the volume of bids and offers for a bond on the ASX website, or even better, look at the bond's market depth on your broker's website.

What you will learn next

In this module we looked at the basics of a bond:

- They are an income producing investment that can be traded on ASX.
- Tend not to have the volatility of shares, but their prices do move up and down.
- They are not shares - they do not represent part ownership, instead they are a loan to a company and have a limited life.

In the next module we cover what you need to know before you buy a bond. Learn how their income is measured and how you can compare different bonds.

Summary

- Bonds traded on ASX:
  - promise to pay a defined income stream
  - offer to return their face value at maturity
  - enable you to diversify your investments
  - are bought and sold just like shares.
- Bonds represent a loan by the investor to the issuer. For the term of the investment the issuer pays you income in the form of interest. The issuer promises to repay you the face value of your bonds at a specified time in the future.
- Each bond is unique. It is essential to review each bond's prospectus to learn about the type of interest paid, who the issuer is, and the level of risk the bond presents.
- Bonds can vary from so called 'simple bonds' to more complex debt securities. When reviewing a prospectus look closely for complex features that allow the issuer to:
  - reset interest payments
  - change the coupon rates
  - extend the term of issue
  - any conversion into shares, perpetual structure or subordinated debt.
- All of these features are typically associated with 'hybrid' securities and present a different range of risks than simple bonds.