Bond Investing 101

Almost everyone in New Zealand will have heard of bonds, and indeed most New Zealanders are likely to hold an investment in bonds either in private investment portfolios or through their KiwiSaver retirement plans. Bonds are considered one of the four major asset classes along with shares, property and cash, yet are the least understood investment sector.

So what are bonds? Bonds are basically IOUs issued by governments, companies, banks and even international institutions, such as the International Monetary Fund. The investor becomes the creditor while the borrower becomes the debtor. There is a principle component which is repaid at maturity but the investor also receives interest payments, called coupons. Bonds have an intimate relationship with interest rates in that when interest rates fall, bond prices increase and vice versa. The overall return on a bond, referred to as the 'yield', is essentially a function of current interest rates plus an extra return for bearing the risk, with bond holders of riskier companies generally expecting to receive a higher return. Government backed bonds generally have lower yields than corporate bonds as it is very unlikely that a Government will default on the repayment of capital at maturity.

Bond investing involves a number of risks therefore it is important to weigh up the advantages and disadvantages which may include interest rate risks, default risk, inflation risk, liquidity risk and early encashment risk. To manage such risks, many investors choose to invest in bonds though a professionally managed fund. Professional fund managers will buy and sell suitable bonds in order to produce returns that meet the objectives of that particular fund. They will often have access to bonds which are not available to the general investing public or will spot differences in market pricing and act on those differences in order to produce returns for their investors.

When a new bond is issued, a Product Disclosure Statement (PDS) must be produced. Recent new laws now require a PDS to be in clear language so that investors can make informed decisions, and must include essential information such as what the financial product is, information about the organisation offering the product, key terms and key risks affecting the investment. Credit ratings services such as Moodys, Fitch or Standard & Poors may give ratings to bond issues, which helps identify the quality of a particular bond. For investors looking for further guidance, The Financial Markets Authority website contains information on this and many other investment topics; www.fma.govt.nz/consumers If in doubt, seek the advice of an Authorised Financial Adviser who is qualified and experienced in this area of financial advice.

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