A Short Guide to the Importance of Bonds

When most people think of investing, equities are the main asset class that spring to mind. We are all familiar with the fortunes of the main FTSE companies. The excitement of buying low and selling high is what tempts many investors into the market in the first place.

While equities are the key to long-term growth, we should not ignore the other asset classes. Diversification helps to control volatility and ensure that even if your chosen shares go into freefall, that your portfolio has some stability. Equally, some asset classes tend to thrive when share prices are plummeting.

In this guide, we focus on bonds, or fixed interest securities. What are they, how do they behave, and why should you include them in your portfolio?

What is a Bond?

Put simply, a bond is a loan to a company or government. Loans to the UK government are known as gilts. When you invest in a bond, you receive regular interest payments, known as coupons. The interest rate is fixed at outset, and at the end of the term, you receive back your capital.

Bonds can be bought and sold, so if you need your money back, you don't usually need to wait until maturity. But the price of the bond will fluctuate according to supply and demand. You might make a profit, or you might not receive your initial investment back in full.

As the interest rate doesn't change, this can affect the demand for the bond. For example, if £1,000 is invested in a bond when it is first issued, at an interest rate of 3%, the annual income generated will be £30. But if the second-hand price of the bond rises to £1,200, the interest is still £30, as it is based on the initial loan rather than the current price. This works out as an interest rate of 2.5%, which is less desirable to new investors.

Some bonds are linked to inflation, so that the interest rate and the capital repayment are increased in line with inflation. These are known as index-linked securities, and most commonly take the form of UK gilts.

How to Invest

Bonds can be bought directly, either at the point of issue, or on the second-hand market.

But most investors buy bonds through investment funds or managed portfolios. Buying and selling is taken care of behind the scenes by fund managers. This has the following benefits:

- Even small portfolios can buy into a wide range of bonds. This helps with diversification.
- As the fund manager is buying and selling large amounts on behalf of multiple investors, the charges are usually lower than an individual investor trading directly.

- The fund manager has the resources and research capabilities to select the most suitable assets to invest in.

A fund which holds bonds may be:

1. A general fixed-interest fund, which holds a wide range of corporate and government bonds.
2. A more specialist fund, which holds bonds within a particular sector, for example index-linked gilts or emerging market corporate bonds.
3. A multi-asset fund which holds bonds alongside equities, property and cash.

A detailed knowledge of the bond market is not required to gain the benefits of bond investing. There are multiple funds and portfolios available which provide bond exposure, without the need to manage the assets directly.

Risk

Bonds are not without risk, but the prices are usually more stable than equities. The stability of bonds can help to offset the volatility of equities in a diversified portfolio.

Risk can vary even within the bond sector. For example, a UK gilt is considered to be a low-risk investment. As a result, the interest rates are usually not particularly high, especially where the gilt was issued during the current period of low interest rates, and even more so where the term until maturity is short.

Corporate bonds often offer a higher interest rate, but carry a higher level of risk, particularly where the company is smaller, less established, or operating within a less developed economy.

If a company issuing a corporate bond fails, a total loss of capital is possible. However, as a creditor of the company, the investor takes a higher priority than a shareholder when liquidating the company's assets.

Supply and Demand

The price of the bond will fluctuate depending on the level of demand. The following market conditions can impact on the demand (and therefore the price) of bonds:

- Where interest rates are low, demand for bonds may be higher as they offer a better alternative to cash.
- If inflation is high, demand for bonds can increase, as index-linked bonds in particular offer inflation-proofing. This helps to ensure that the investment retains its purchasing power, even as prices rise.
- During a recession or market volatility, demand for bonds can increase, as investors seek stability and move away from equities.
- Where equities are performing well, demand for bonds can reduce, as investors seek higher growth.

- The price of a bond will be influenced by the credit rating of the company or government issuing it. Investors will be reluctant to invest in a poorly performing company unless they are incentivised by high interest.

The Place of Bonds in a Portfolio

We would encourage investors to hold bonds as part of a diversified portfolio for these main reasons:

- Holding a proportion of a portfolio in bonds can help to control the risk level. While we cannot predict how the markets will perform, we can say with certainty that a portfolio holding 40% in equities and 60% in bonds is lower risk than a portfolio with the opposite allocation.
- As bond prices often rise as equities are falling, a diversified portfolio can reduce the impact of a market crash.
- Bonds can facilitate a steady stream of income within a portfolio.

As investment markets are generally efficient, we do not advocate buying and selling bonds to gain an advantage. Over the long-term, equities generally outperform bonds, although there is always the risk that a company could fail. Over-exposure to a single company or sector can worsen losses, which then take many years to recover from.

Diversification is the key. While markets are unpredictable and world events are already priced in, the best way to gain an advantage is to hold multiple different asset types. This way, your portfolio will benefit from the upside, while lessening the impact of the downside.

Please don’t hesitate to contact me if you would like to find out more about your investment options.

Thank you

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