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Spotlight – How Bonds affect your portfolio 7th November 2022

How Bond can Markets Affect Your Portfolio

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How Bond Markets Affect Your Portfolio

We have seen significant volatility in financial markets over the last year. Some equity volatility was to be expected given everything that is going on in the world. But generally, investors expect bond investments to be more stable than equities and not to fall at the same time. 2022 has been an unusual year, and many bond investors have seen losses on par with equities.

Even if you don't hold bonds directly, you may own bond funds or multi-asset funds, in which case you have probably seen the impact of turbulence in the bond market. Additionally, occupational pension schemes, which invest heavily in gilts or debt securities , have also been affected.

So what is causing this volatility, and is there anything you need to do about it?

A Short Guide to Bonds

A bond is effectively a loan to a company or government. Loans to the UK government are known as gilts and the US as Government Sovereign Bonds like those issued by the Treasury T-Bonds. The entire category of bonds issued by a government treasury is often collectively referred to as treasuries.

Bonds have a fixed maturity date and an interest rate known as a 'coupon.' The interest rate is fixed as a percentage of the original investment and must be paid by the issuer until maturity.

Bonds can be bought from the original issuer or traded on the second-hand market. The price of existing bonds fluctuates with supply and demand in the same way as equities. However, because bonds come with a fixed rate of interest and the promise of a capital repayment, they tend not to be as volatile.

Even when the price changes, the interest payment remains the same, which can make it attractive to buy bonds which have dropped in price.

You can buy bonds either directly, through an investment manager, or hold them within an investment fund. Or through and ETF* which most of you can see held in your portfolio.

**An exchange-traded fund (ETF) is a type of pooled investment security that operates much like a mutual fund. Typically, ETFs will track a particular index, sector, commodity, or other assets, but unlike Mutual funds, ETFs can be purchased or sold on a stock exchange the same way that a regular stock can. They are generally passive investments.*

There are four main risks involved when investing in bonds:

- The risk that the price will fall and you will get back less than you invested.
- The risk that interest rates will rise and existing bonds will offer a poor rate in comparison.
- The risk that inflation will rise and your investment will lose value in real terms.
- The risk that the issuer will fail and you will lose your investment.

Types of Bonds

The risk and return spectrum of bonds can vary depending on several factors, including the credit rating of the issuer and the term until maturity.

Types of bond include:

- UK gilts, i.e. loans to the government or US T-Bonds, loans the US Government.
- Index-linked gilts or Treasuries which aim to keep pace with inflation.
- UK or US corporate bonds issued by companies.
- Overseas government bonds.
- Overseas corporate bonds.

A bond issued by an established, profitable company is likely to be less volatile than a bond issued by a small company in an emerging economy. However, riskier bonds tend to pay higher interest rates to compensate for the added risk.

The term of the bond can also contribute to the risk. The longer the term, the greater the chance that the economy could change or the issuer could default. Long-dated bonds tend to pay a higher rate of interest. However, this is not always the case and the rates for bonds will depend on the economic outlook.

Factors Affecting Bonds

When inflation is rising, this generally means that demand for goods and services is increasing, which means that prices need to go up. Steady inflation is a good thing, as it means the economy is prospering. But sometimes prices can rise too quickly as it has done this year, which can put a strain on finances and push some people into poverty.

When inflation is high, central banks will typically tighten monetary policy. This usually means increasing interest rates, making it more attractive to save and invest, and less appealing to spend and borrow. Borrowing can also become more difficult.

Higher interest rates mean that newly issued bonds also need to increase their rates to remain competitive. Existing bonds may be sold off as investors seek higher rewards or less risk. This can cause the price to drop. However, once prices reach a low point, the bond may become attractive to investors again as the interest rate looks favourable compared to the price. Bond volatility tends to be self-limiting.

Typically in this situation, the price of equities will rise, however this is less likely to happen when inflation is rising but growth is slowing down.

Gilts and T-Bonds are typically regarded as a safe haven as the loans are backed by the either the UK or US government. However, UK debt is a major source of concern at the moment and the value of Sterling has plummeted. UK Gilts have been the hardest hit amidst recent turbulence in the bond market.

In the UK the Bank of England is the largest investor in UK debt and has recently purchased a further £19.3 billion in gilts. The aim was to stop the price of gilts falling further and to help restore confidence in the UK market.

Should You Still Hold Bonds in Your Portfolio?

The purpose of holdings bonds in a portfolio is to provide stability, and to offset some of the volatility created by equity holdings.

In the current market conditions, bonds are behaving more like equities. This can be concerning, especially if you are approaching retirement and have transitioned your money into lower risk assets.

However, it is expected that bonds will be volatile sometimes and that occasionally they become correlated with equities. Over the longer term, bonds do act as a diversifier, but it can take several years to really see the benefits.

UK gilts have taken the brunt of the recent volatility, but other types of bonds (including overseas bonds) have not fared so badly. This illustrates the importance of diversifying your bond holdings as well as your overall portfolio.

The basic principles of investing do not change, despite what is happening in the markets. If you diversify your investments, invest for the long-term, and avoid reacting to market events, it is likely that you will see positive returns.

Please don’t hesitate to contact a me to find out more about your investment options

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