

Trading in Bonds

BY GIA SINGH

The current sentiment in the local stock market seems to be one of low confidence. Investors are very cautious about putting their money into the stock market which is in somewhat of a continuous decline, notwithstanding the strong fundamentals being displayed. Our local conglomerates and manufacturing companies released results with significant double digit growth, however this does not seem sufficient for the market to slip from the non-relenting bear hold! As a result of this low confidence, limited liquidity, small investor base and lack of institutional presence, many investors have been shifting their investments or rebalancing their portfolios to have a stronger weighting in fixed income securities. In other words, they are leaning towards a more conservative portfolio.

In an effort to tighten liquidity in the financial system, the Government of Trinidad and Tobago has implemented strategies to soak up excess liquidity through the issuing of bonds to the general public. In so doing the Government is also fulfilling its role in developing the local capital market with a focus on the government bond market. Additionally, the Securities Dealers Association of Trinidad and Tobago (SDATT) have been collaborating with the Central Bank and the Trinidad and Tobago Stock Exchange to develop a platform for executing bond trades. We can therefore expect to see an upsurge in the market activity for bond trading in the local market in the very near future. My intent in this article is to introduce bond securities and explain the characteristics associated with this type of investment as well as show the relationship between a bond's yield and its price.

Very simply, a bond is an IOU given by a borrower (the issuer) to the lender (the investor). In the situation above the government is taking a loan because it needs to get money out of the system in order to bring down inflation, however this is not always the case. There are situations where a bond is issued for the sole purpose of raising funds. Both governments and companies can issue bonds and other debt instruments to the general public in an effort to raise funds which cannot be provided by a bank or financial institution.

Bonds are characterized by their face value, coupon rate, maturity and issuer. Once you are familiar with these characteristics you will have a greater understanding of the fundamental value of a bond, which in turn can help you to better manage your portfolio.

Value

Firstly, let's take a look at the term face value, which is also known as par value. This is the value that the bondholder will receive once the bond matures. It is important to note that the face or par value may not be the same as the price of the bond since a bond could trade for less than (discount) or more than (premium) its face value. When a bond's price is equal to its face value then we say that bond traded at par or face value. In such a case, the investor would require something extra in order to loan the money to the borrower. This brings me to the next characteristic which is known as the Coupon.

Coupon

The coupon is the interest that the bondholder will receive over the life of the bond. It is usually set at a fixed rate and is expressed as a percentage of the par value. For example, if a bond pays a coupon of 6 per cent and has a par value of \$1,000, then the issuer of the bond will pay \$60 in interest a year until the bond matures. This type of bond is known as a fixed-rate bond. However, there is also the possibility that a bond will pay an adjustable interest rate that may be tied to market rates, for example the rate on Treasury Bills. This type of bond is known as a floating-rate bond. Additionally, some bonds do not pay any coupon but are instead sold at a discount to par value.

Maturity

The bond is redeemed by the issuer at the maturity date and the investor is paid the face value on the security. A bond that matures in one year would be much more predictable and thus less risky than one that matures in let's say twenty years. Therefore, in general, the longer the time to maturity, the higher the interest rate. Additionally, a longer term bond will tend to fluctuate more than a shorter term bond, *ceteris paribus*.

Issuer

When investing in bonds, a very important factor to be considered is the default risk associated with the Issuer. That is, what is the risk that the borrower will not be able to pay back the debt? If the risk is high, then the issuer must compensate with a high yield in order to attract investors. The underlying principle being- the higher the risk, the higher the return. Government issued debt securities are generally more secure when compared to those of companies. This is because it is less likely for a government to default on its payment or to become bankrupt, since they can always bring in future revenue through taxation. Thus, government securities are known as risk-free assets. In terms of determining the default risk of companies and governments, investors use rating agencies to determine credit worthiness or the investment grade of the bond. International rating agencies include Moody's Standard & Poor's and Fitch. Additionally, since 2004 CariCRIS was established as the Caribbean's Regional Credit Rating Agency.

Yield and Yield to Maturity

The yield or return on a bond is calculated using the formula: $\text{yield} = \frac{\text{coupon amount}}{\text{price of the bond}}$. Thus, when a bond is purchased at par the yield = interest rate. If the bond price is below the face value the yield goes up and conversely if the price goes higher than face value the yield goes down. As such, a bond's price and yield are inversely related. However, most investors are interested in calculating the yield to maturity on a bond which shows the total return if the bond is held to maturity. The calculation takes into account all interest payments and assumes that these payments are re-invested at the current yield on the bond in addition to any gain or loss, depending on whether the bond was purchased at a discount or premium.

Price

All the characteristics previously mentioned affect the price of a bond. However the most crucial factor which determines the price of a bond is prevailing interest rates in the economy. When interest rates rise, prices of all bonds in that market fall which then has the effect of raising yields on older bonds to bring them into alignment with the new bonds which have to be issued with higher coupons to compensate for higher interest rates. The reverse is true when interest rates fall: prices of bonds in the market rise, which leads to the lowering of yields on older bonds to bring them in line with new bonds which are issued with lower coupons.

The terms discussed in this article only provide a basic introduction to debt financing. Investing in Bonds can be quite complex and sophisticated, but the main thing to keep in mind is that diversification is key. Fixed Income Securities and Adjustable Rate Instruments should be mixed and weighted according to your investment profile and risk tolerance.

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