

BY ROWLAND THOMAS

You may recall an article published in August this year by one of my colleagues which explored basic bond characteristics. However, in this article I intend to take the fundamentals a few steps further and discuss: the advantages of bonds, the elements of an efficient bond market and how it relates to the current bond market in Trinidad and Tobago.

One of the major advantages of bonds as an investment vehicle is the fact that they guarantee either a specific rate of return or one which can be anticipated at the onset of the investment. For instance a Fixed Rate Bond as the name implies provides the investor with a fixed rate of return in the form of coupon payments. Investors find great solace in this aspect as they know exactly what will be received before making any investment commitments. While Zero Coupon Bonds do not pay any interest, they also offer a guaranteed return which is equal to the difference between the invested amount and the face value of the security. Although some will argue that interest rates on Floating and Variable Rate Bonds (depending on how and on what basis they are structured) are dependent on the investor's predictions about future market conditions, they still provide some idea about their future cash.

With such a degree of certainty for future income, both individuals and companies are afforded the ability to more accurately budget their cash flows. Individuals may find this significant as they plan the usage of interest to be received from these investments to meet planned expenses such as a long desired vacation. Companies would also be able to more accurately time their funding costs with interest income or may use interest received to pay down loan balances.

Another benefit of bonds is their relative safety. The principal invested is generally considered to be protected if the bond is held to maturity. While there is the possibility that the issuer can default on payments of principal, investors can assess this level of risk by reviewing the ratings assigned to the issuers by independent rating agencies. These assigned ratings are made up of many aspects reflecting the issuer's ability to repay long term as opposed to short-term borrowings, their expectations on issuer's chance of defaulting on the payments etc. Ratings can usually be found for government issued bonds but most corporate bonds in the Caribbean region are un-rated therefore leaving investors to make their own risk assessments.

These key advantages mentioned above make bonds a perfect candidate for inclusion in portfolios as they provide some sense of stability to overall returns. This type of investment vehicle is very important for firms that manage pension funds since there are strict requirements regarding the percentages of bonds held on their books. Since you cannot gamble with people's retirement money, it is prudent to have a larger mix of fixed income securities which provide stable income flows rather than income flows which are driven by the more risky investments like equities.

This brings me to the second part of my article, which will highlight the key elements or requirements for an efficient bond market. Firstly, for a bond market to be efficient it must possess a fair degree of liquidity. This means that at a known price, the security can

be bought or sold quickly without a drastic change in that price. For this criteria to hold the market should have a large number of investors who are willing to purchase or sell the security at varying price levels.

Secondly, the availability of timely and accurate information is also important. This means that all information about transactions that may have occurred in the past as well as the present levels of both supply and demand for the security must be readily available. This would allow for technical analysis of the security's price and volume trends that may be used to give an indication about how these aspects will fare in the future. Prices in a well functioning market must adjust quickly to reflect any new information that affects the valuation of the security.

Finally, transaction costs should be somewhat consistent throughout the market. This is usually the case in a well functioning bond market since there are many dealers who through competition reduce the chance of widely varying or exorbitant costs.

Currently in Trinidad and Tobago the purchase of bonds after they have been issued is done through negotiated deals. This involves a one on one negotiation between the seller of the bond and the prospective buyer. There is no way to determine if the price to be paid for the security is truly fair as there is no independent pricing source available. The negotiation therefore results in both parties receiving a price that is only fair in their eyes which is based on their analysis and negotiating skills.

You may ask, "If both parties are receiving what they deem to be fair, what is the issue?" Well, the problem here is that every time this security is bought or sold it is mainly done at a price required by the party with stronger negotiating skills. This violates one of the main requirements of an efficient bond market, as each sale is done at a different price that is unknown until negotiations have been completed. There may also be drastic changes in prices between one sale and the other while completion of the negotiation for a sale is not guaranteed to be a quick process.

Negotiated deals are not public information making it impossible for an individual to gain fair view of the market. This is because they may not be able to get historical and present bond transaction information from more than one source. Also, in Trinidad it is extremely difficult to firstly determine which transactions, if any, have occurred and furthermore at what prices and in what volumes. All companies currently consider this type information confidential.

The effect of new information on the price of a bond is subjective since prices are determined through negotiation only. Thus, one party may place more emphasis upon new information than the other but may lack the required negotiating skills to effectively factor this into the price negotiations.

Since transaction costs are not publicly displayed there are widely varying charges which are applied to similar transactions.

All this being said we can clearly see that the bond market in Trinidad and Tobago is not a well functioning market. This has lead to the Central Bank of Trinidad and Tobago in conjunction with the Trinidad and Tobago Stock Exchange establishing a bond exchange which should effectively address all of these failing points. This exchange will allow for the electronic trading of bonds giving the market the desired transparency needed to function effectively. However, initially it will only be available for recent Government bonds, with corporate bonds to be added once the system is successful.

Investors will therefore be able to benefit from accurate and fair pricing, increased liquidity in the markets, lowered transaction costs and more accurate data on which to base their analysis.

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