Demystifying bonds in a matter of minutes

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What is a bond? How does this financial asset work? What are the benefits? These are just some of the questions a retail investor might have when a financial adviser asks whether they would like to invest in equities or bonds.

Here are a few pointers to help you get to grips with bonds – an asset class that is often poorly understood despite the fact that many people hold bonds, without necessarily knowing they do, through structures such as employee savings schemes or life insurance policies.

What is a bond?

A bond is **a loan issued by a government, local authority, or company to finance its economic activity or development (e.g. roads, telecommunication services, acquisitions, etc.).** When an investor buys a bond, they are lending money in exchange for a return (the coupon) over a specific term agreed at the outset. At maturity, provided it has not declared bankruptcy, the issuer repays the capital it had borrowed initially.

A bond is **a contract** whereby the issuer undertakes to repay the loan. **The most important criterion when investing** in bonds is therefore **the issuer's capacity to repay its debt** – its creditworthiness – irrespective of its growth prospects. So, it is entirely possible to buy bonds issued by companies recording little or no income growth, provided that they are in a position to settle their debts.

Bonds are the most common type of "fixed income" financial asset. Fixed income securities are referred to as such because they provide investors with a steady rate of return, unlike traditional shares for example, whose dividends can fluctuate substantially.

The main characteristics of a bond

- **The nominal value** is the value of the bond when it is issued
- **The maturity** represents the term of the loan
- **The coupon** represents the interest paid
- **The issue currency** is the currency in which the bond was issued
- **The credit rating** measures the creditworthiness of the issuer
- **The type of interest rate** defines whether the bond offers fixed, variable, or no returns

How a bond works

Contrary to popular belief, **the value of a bond is not fixed** over time. It changes between the bond's issue and maturity date. **The investor may therefore find themselves holding a bond worth less than the amount they paid for it.** In addition to the law of supply and demand, variations in interest rates can have a direct impact on bond prices.

Prior to maturity, the value of a bond has an inverse relationship with interest rates: it rises if interest rates fall and vice versa.

Why do levels of return vary so widely?

The **return paid to the investor depends on the term of the loan and the risk profile** of the issuer. Just like with a mortgage, **the longer the loan term, the higher the interest rate.** Similarly, **the higher the risk profile of the issuer, the greater the interest rate on the bond.**

There are **several categories of bond** to reflect the issuer's risk profile. The **investment grade** category is for issuers with the highest scores from rating agencies (Standard & Poor, Moody's, Fitch Ratings, etc.). The **high yield** category is for higher-risk issuers.

The advantages of bonds

Provided that the issuer does not declare bankruptcy, bondholders are guaranteed **fixed and regular income at set intervals over a given period.** The only exception to this is zero coupon bonds (see the Main types of bond section).

The creditor, i.e. the person holding the bond, **takes precedence over shareholders in the event of the bankruptcy** of the issuer. In this case, the company's assets are sold to repay its creditors first, with shareholders dividing up any remaining cash.

Bonds can be used to **diversify the investor's securities portfolio.**

Provided the issuer does not go bankrupt, bonds **protect the capital** if the investor holds them to maturity.

Main types of bond

Fixed income bonds offer a return that is fixed at the time of issue and does not change over the life cycle of the security.

Variable rate bonds offer a return that varies based on changes to financial market interest rates.

Zero coupon bonds do not generate a regular return. Interest is accumulated over the life cycle of the loan and paid in full at maturity.

Inflation-linked bonds protect investors against price rises, as the interest paid by the issuer and the

Inflation-linked bonds protect investors against price rises, as the interest paid by the issuer and the capital repaid are tied to inflation.

Lastly, there are bonds that can be converted to or redeemed as equity:**convertible bonds** and **bonds redeemable in shares.**

What is the difference between the nominal rate and the real rate?

When an investor buys a bond, they are lending money in exchange for a return determined by the interest rate agreed between the investor and the borrower. This is the rate actually paid, which is also known as the **nominal rate.**

However, for a more realistic estimate of the actual return on the bond for the investor, it is important to think in “real” rather than “nominal” terms to take price changes into account. To that end, the nominal rate is adjusted for inflation. This is what is referred to as the **real rate** (or real return).

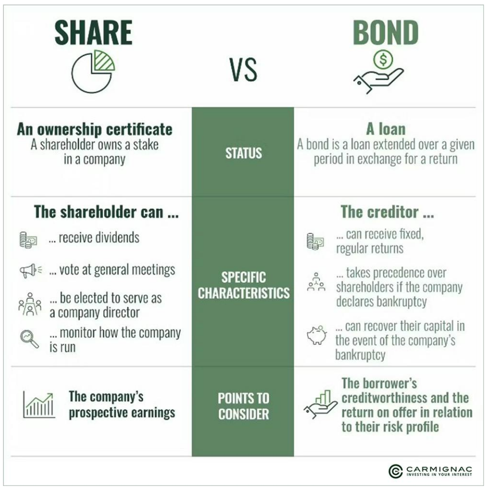
How to invest in bonds

It’s possible to invest directly in bonds but it can be very expensive, as the nominal value of a bond generally runs into the tens, or even hundreds, of thousands of euros. **The easiest way for a retail investor to invest in bonds is by going through an investment fund**.

Such funds, which are managed by professionals, tap into the**knowledge and experience** of experts to **select securities** in which to invest and also**diversify** risks and investments.

At Carmignac, we draw on **over 30 years of experience focusing exclusively on managing the savings** of our clients. **We invest in our clients’ best interests** by using our expertise to help them achieve their long-term savings objectives.

Understanding the difference between bonds and equities:



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