BONDS 101

FUTUREGROWTH
/ ASSET MANAGEMENT

BORROWER

I need funding.

These are my options:

- Bank loan
- Raise equity
- Own cash
- **BOND MARKET**

BOND AUCTION

A mechanism for a borrower (governments, companies) to raise funding by issuing bond certificates to a number of lenders. Bond auctions allow borrowers to access a diverse pool of lenders, versus borrowing all the funds from a single bank.

LENDERS

The interest to be paid to lenders (coupon) is determined by:

- Default/credit risk: Will I get my money back?
- Liquidity risk: How long is my money 'tied up'?
- Inflation risk: Will the interest compensate me for inflation

A pension fund is a typical example of a lender.

WHAT IS A BOND?

A bond certificate is a promise to repay the loan amount plus interest over the life of a bond. There are many different types of bonds e.g. nominal bonds, inflation-linked bonds, floating rate bonds, etc. Here we will be explaining nominal bonds.

R1,000	50	50	50	50	50	50	50	50	50	50	R1,000

R1000 initial loan amount
5 year, 10% (paid semi-annually) coupon bond
"A bundle of cash flows" paid over the life of the bond

DECISION TO BUY A BOND

WHAT IS A COUPON?

The coupon reflects the interest rate earned by the lender. The coupon is paid periodically (usually semi-annually) to compensate the lender for the multiple risks they bear.

WHAT IS YIELD TO MATURITY?

Yield to maturity represents the total return you will earn on a bond from the date you buy the bond until the maturity of the bond, assuming that you hold the bond to maturity.

LIFE OF A BOND

DAY 1

Lender gives R1000 to borrower. Borrower starts construction.

EVERY 6 MONTHS

Borrower pays lender coupons (bundles of cash flow e.g. R50) to compensate for risks they bear.

END OF LOAN TERM

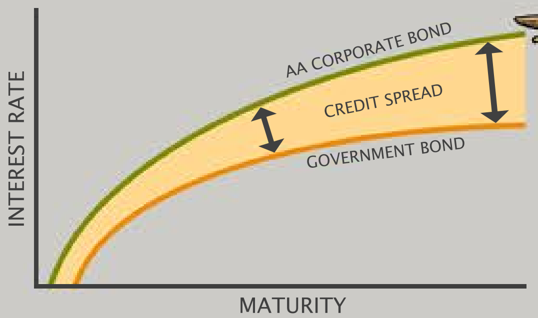
Borrower pays R1000 back to lender.

THE INVERSE RELATIONSHIP BETWEEN YIELD AND PRICE

The price at which you buy a bond is determined by the interest rate at which it trades in the market. Generally as interest rates rise, the price of a bond will reduce and vice versa.

WHAT IS A CREDIT SPREAD?

Governments are generally unlikely to default on their own debt, as they can print money, so they are considered 'risk-free'. Corporates do not have this luxury, therefore corporate bonds will have higher interest rates than government bonds of a similar term, reflecting the higher default risk.



The difference between corporate and government interest rates is called the credit spread. The 'riskier' the corporate, the larger the credit spread.

WHAT HAPPENS IN THE CASE OF DEFAULT?

In the event of a default and possible financial loss, a recovery/workout process is implemented to ensure the best outcome for our pension fund clients.

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