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IS IT TIME TO INVEST IN BONDS?

What role should bonds have in your portfolio?

Last year was one of those years when investors looked nervously at their portfolios. As the coronavirus pandemic raged, markets tumbled. Even as news of vaccines brought strong rallies, it wasn't for the faint-hearted.

Meanwhile, already meagre interest rates and inflation were driven to new lows, while the prospect of rates rising anytime soon seems unlikely as we go into the new year.

One alternative is to look at bonds. This investment class typically pays higher interest than the banks, and comes with less volatility than shares (although there's still some risk).

WHAT ARE BONDS?

Bonds are debt which is sold to investors, usually for a fixed interest rate and fixed term. They can be issued by governments – in the UK, these are called gilts – or by companies, when they're called corporate bonds.

In simple terms, you buy a bond directly and hold it until redemption while being paid interest. When it matures you receive your capital sum back.

For example, you could buy a corporate bond for £10,000 paying 4% interest (the coupon) which matures in ten years.

Each year you would receive £400 interest (probably paid in two instalments), and then when the ten years are up, you would receive your original £10,000 back.

In this sense, it might seem like any old savings account, but it carries more risk. If the company goes bankrupt, you are unlikely to receive all of your original sum or remaining interest back. And unlike a bank account, the Financial Services Compensation Scheme does not apply.

So there is credit or default risk there, and as you probably understand, to compensate for this risk, the interest rates will generally be higher than you could get from a bank account. Though that's not difficult in the current climate.

Credit ratings are what indicate the level of risk and reward associated with bonds.

These range from AAA (the most secure, and therefore able to offer the least attractive interest rates) down to C and then D for companies which have defaulted. You might get higher interest rates at this end of the market, but your capital is exposed to far greater risk.

THE ROLE OF BONDS IN A PORTFOLIO

Fixed-rate bonds tend to offer more stability than shares. If all goes to plan, you know what you are getting with them because the interest rate and redemption date are pre-determined.

This can make them attractive if you are nearing a financial goal and want to remove volatility from your portfolio.

They can also offer asset-class diversity to any portfolio when used in combination with other assets, such as shares and property. As they pay regular interest, they can also be attractive if you are seeking to generate income.

Historically, they may not be as volatile, but they have not provided superior returns to shares over the long term. So, if you are seeking long-term growth and are not concerned with short-term fluctuations they might not be for you.

HOW CAN YOU INVEST IN THEM?

In our example, we described buying a bond directly from a company and holding it to redemption, but this is not the only way of gaining exposure to bonds.

It's probably not even the most common. Because as well as buying bonds directly at issue, there is also a secondary bond market. And – as with most asset classes – you can also access them through funds.

Secondary bond market

It can take a moment to get your head around this market.

Bonds can trade at prices higher or lower than their face value (the capital sum you will get back at the end). A combination of the interest rate being paid and the current financial position of the company which issued it determines the price fluctuation.

When interest rates on cash go down, bond prices go up because their yield becomes more attractive. And therefore when interest rates on cash go up, bond prices go down.

If a company appears in poor shape, bond holders will sell their bonds for less than they are worth because they are concerned they may lose more capital if the company fails.

The buyer picks up an apparent bargain, but it comes with the risk of failure and vice versa if the company grows from a weak position to rude health.

So to build on the first example, but this time in the secondary bond market: if cash interest rates generally deteriorated, that 4% corporate bond might trade for the increased amount of £10,500 – reflecting the desirability of the higher interest rate.

The new buyer would receive the favourable interest rate (still 4% of £10,000 though, not the price paid), and when it matures they would only get the face value of £10,000 back – so they make a £500 capital loss. And the seller has given up the good interest rate for a £500 capital gain.

Bond funds

Bond funds give you exposure but have other facets to consider.

With these, a fund manager will be trading a portfolio of bonds and individual investors like you can invest into it and gain access to this spread of investments. A significant advantage of this is that you get diversity and so the risk is pooled.

The fund manager will typically be investing in dozens of bonds, so even if a few were to fail, it won't wipe you out in the same way that a single bond holding would.

But it is important to understand that a bond fund does not behave in quite the predictable way that individual bonds do.

The price of the units you purchase in the funds will fluctuate according to the bond market and the trades the fund manager makes. In normal markets, this fluctuation should not be as great as in funds investing solely in shares.

It's worth adding there are more than just fixed-interest-style bonds. A novice is unlikely to get involved in these, but when looking at bond funds you may see reference to investments like zero-coupon bonds and convertible bonds, for example, which have different characteristics to the classic fixed-income bond.

Bond fund managers will have varying objectives which determine the investment style. Some may simply track an index, others will try to pay a reliable income, and others might seek to deliver some capital growth. So you can make a fund choice which aligns with your own goals.

ARE BONDS FOR YOU?

As you can see, bonds hold some attractive features: reliable income, lower volatility and diversity when held as part of a broader portfolio. But they do still carry risk, and shares generally outperform them over the longer term.

There are several ways to gain exposure to them meaning that most people will be able to find an approach that suits them.

We would never recommend diving into an investment without fully understanding it. But if you are interested in what bonds have to offer, then we can book a review and talk through where they could sit in your portfolio.

Contact us to arrange a portfolio consultation.

IMPORTANT INFORMATION

This document is solely for information purposes and nothing in it is intended to constitute advice or a recommendation. You should not make any investment decisions based on its content. Investment values can fluctuate and you might not get back the amount you invest.

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