

Fixed Income for Freshies

(Part 1/2)



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*B*onds or fixed income typically constitute a core component of the portfolios of pension and insurance funds due to its stable nature and income-producing abilities. However, not much of its intricacies are known to retail investors because of confusing terminology and jargons.

In our latest Fundamental Flash, we attempt to break down some of these perplexing terms as well as demystify other common misunderstandings about this stable asset class.

< What Is A Bond? >

A bond is a debt or fixed income instrument just like any common loan.

Issuers (borrowers) such as companies and governments tap the bond market to meet their funding needs such as capital expenditure, general working capital or refinancing of debts.

Investors (lenders) who invest into these bonds will receive an annual coupon or interest payment as well as the principal amount at the end of the maturity.

< Price >

The price is the amount investors are willing to pay for the bond. The price of a bond can fluctuate daily according to supply and demand dynamics as well as other market forces.

< Yield >

The rate of return you get on a bond. For example, if Bond ABC has a price of \$100 and pays an annual interest/coupon of \$10, then its yield is 10%. The coupon payment stays constant, whilst the bond yield moves inversely with the price (further explanation below).

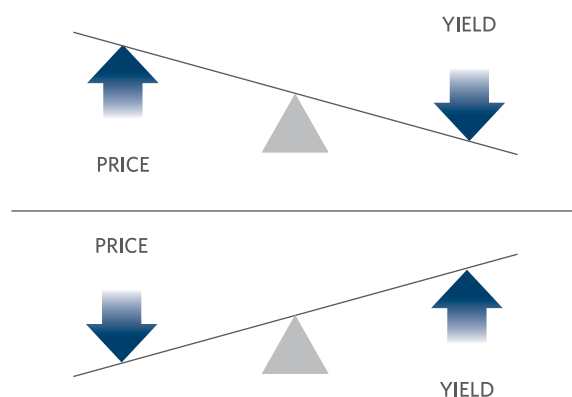
$$\frac{10 \text{ (annual interest/coupon)}}{100 \text{ (price)}} \times 100\% = 10\% \text{ (yield)}$$

< Bond Yield Vs. Price >

Bond prices move inversely to yield. Referring to the same formula above, if the price of the bond increases to more than \$100, then

the yield will now fall below 10%, because we are now dividing against a higher amount. If the price of the bond is lower, we will get a higher yield.

Another way to understand this is to imagine that you're a bond investor yourself. The lower the price you pay for a bond, the more yield you'll be able to extract from your investment.



< Yield To Maturity (YTM) >

The rate of return % on a bond assuming the investor holds it till its maturity date.

< Par Value/Face Value >

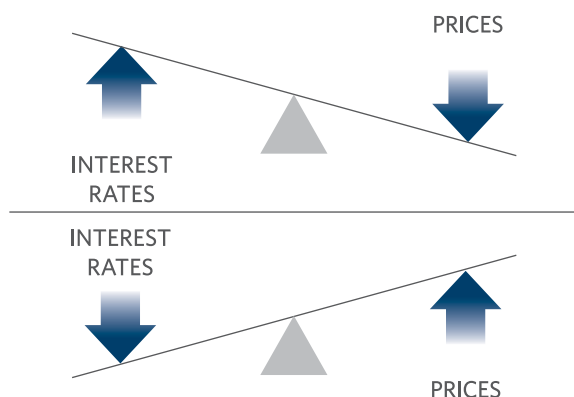
The amount of money that the bond issuer agrees to pay at the end of the bond's maturity. This may or may not be the same as the price of the bond as certain debt papers are issued at a premium or discount.

For example, if a bond is issued at a price of \$80, but its par value is \$100 that means it was issued at a discount of 20%.

< Inverse Relationship Between Interest Rates And Bond Price >

For example, if interest rates were to rise to 15%, then Bond ABC which only makes a coupon payment of \$10 or generates a 10% yield would now be unattractive because investors can gain a higher yield elsewhere. This would then drive down the price of the bond.

Conversely, if interest rates were to fall to 8%, then Bond ABC which provides a higher coupon payment will be more attractive. This would naturally drive up demand and ultimately the price of the bond.



< Dovish/Hawkish >

These terms are often used to describe monetary policy decisions. A central bank that is dovish supports low interest rate environments in favour of expansionary growth. Conversely, a hawkish central bank supports higher interest rates to keep inflation in check to prevent the economy from overheating.

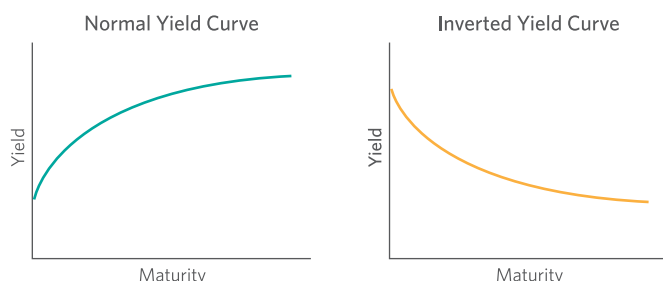
< Duration >

Duration is a measure of the sensitivity of the price of a bond relative to a change in interest rates. This is an important measure because the longer the bond's duration, the more sensitive it is to movement in interest rates.

For example, a bond portfolio with a duration of 10 years tends to suffer a larger drawdown in the event of a rise in interest rates compared to a portfolio with a duration of just 1 year.

< What Is A Yield Curve? >

A yield curve is a graph that plots the yields of bonds across differing maturity dates. Depending on the shape of the yield curve, it may tell us different things about what bond investors are thinking about growth and inflation expectations or interest rate changes.



< Normal Yield Curve >

A normal yield curve is one in which longer-dated bonds have a higher yield compared to short-term bonds. Naturally, a 10-year bond will offer a higher yield compared to a 2-year bond because of the risks associated with lending for a longer period of time.

In terms of economic projections, a normal yield curve implies that growth will be strong in the future with expectations of higher inflation.

< Inverted Yield Curve >

An inverted yield curve is one in which shorter-dated bonds have a higher yield compared to long-term bonds. Whilst it is a rare occurrence, the US yield curve has inverted several times throughout history.

This is typically a signal of an economic slowdown or recession because bond investors are pessimistic about the longer-term outlook.

< What Does It Mean When A Yield Curve Flattens Or Steepens? >

A **steepening** yield curve occurs when:-

- Short-term rates fall faster than long-term rates or;
- Long-term rates increase faster than short-term rates

The shape of the yield is to have 'steepened' as the yield spread between long-term and short-term rates have 'widened'.

A steepening yield curve typically signals stronger economic activity and rising inflation expectations.

A **flattening** yield curve occurs when:-

- Long-term rates fall faster than short-term rates or;
- Short-term rates rise faster than long-term rates

The shape of the yield curve is said to have 'flattened' as the yield spread between long-term and short-term rates have 'narrowed'.

A flattening yield curve is often indicative of economic weakness as it signals inflation could stay low for some time.

< Build Stability With Bonds >

That concludes Part 1 of 2 of our educational series on fixed income. Read Part 2 in the link below, where we delve into the importance of credit ratings and what widening spreads signal to investors.

<https://affinhwangam.com/insights/articles-commentaries>

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