

Investment basics

education series

What is a bond?

When you need a loan, you go to the bank. When governments or corporations need a loan, they issue a bond. It's simply a loan in the form of a security, which means those who invest in the bonds are the lenders.

Bonds are part of the asset class called fixed interest. While there are different types of bonds, all bond investors receive regular interest payments, with full repayment of the initial investment at an agreed date in the future. This can make bonds a less risky investment than shares, but historically bonds have provided a lower long-term return on investment than most asset classes except cash.

Bonds are grouped by maturity

Bonds are issued for a set period. At the end of that period (a bond's maturity date) the bond issuer is required to repay the original loan (the principal). Bonds can be issued with maturity dates ranging from 2 years up to 30 years or more.

Buying and selling bonds

Like most investments, bonds can be bought and sold. A bond's price moves up and down in response to interest rate movements, its maturity date and the performance of other asset classes, such as shares and property.

Bond terms

Face Value – this is the amount the investor will get back once a bond matures – essentially the amount of the original investment.

Maturity – the date the investor's initial investment (principal) will be repaid in the future. Bonds can be issued with a maturity date of many years or a few months.

Interest Rate (or coupon) – is the amount investors receive in regular interest payments.

Some risks of bond investing

Bonds are an important part of a diversified portfolio. For super funds like AustralianSuper, bonds can help balance the risks of investing in other asset classes like shares. Although bond investments generally provide lower long-term returns than most asset classes except cash, the returns from bonds also tend to be less volatile. And because bond prices move in the opposite direction to interest rates, this means that generally bonds perform well when property and shares aren't – because falling interest rates negatively affect share and property markets, but cause bond prices to rise.

However, bond investing also involves some risks:

Interest rate risk – a bond's market value is closely tied to interest rates. Generally, when interest rates rise, bond prices fall, and you may realise a loss if you sell before the bond matures.

Credit risk – credit quality is measured by the bond issuer's ability to meet interest payments on time and to pay back the amount of the original investment. When an issuer misses a payment, the bond is considered to be in default. Some issuers are thought to be less likely to default on a payment, so bonds from these issuers are less risky.

AAA-rated vs sub-investment grade bonds

Bonds are rated according to the credit risk of the issuer. Companies and governments that are considered to have the lowest credit risk have the best rated bonds (often called AAA-rated). As credit risk increases, the bond rating goes down.

Bonds issued by companies or governments that are experiencing financial difficulty have a high credit risk, so are rated the lowest. These are called sub-investment grade bonds, but you may know them as junk bonds.

Interest payments

The regular interest payment made to bond investors is largely determined by the market when the bond is issued, and typically is influenced by the outlook for interest rates, how long the bond is being issued for and the level of risk involved for the investor.

The lower the rating of the bond, the higher the level of risk. Bonds that carry a higher risk need to deliver higher income (interest payments) to encourage investment in the bonds.

Likewise, long-term bonds typically pay higher interest than short-term bonds because you are lending your money for a longer period.

Diversify with bonds

Adding bonds to your investment portfolio can help you diversify your investment. And diversification can help reduce your overall risk – something you'll appreciate should the market decline. Of course, diversification cannot guarantee a profit or protect against a loss in a down market.

How AustralianSuper invests in bonds

AustralianSuper invests in bonds as part of our fixed interest investments in both our PreMixed and DIY Mix investment options. We invest in funds that have a range of bonds with different maturity periods and credit ratings. The investments include government and non-government bonds both here and overseas.

For more information, have a look at our factsheet *What is diversification?* at www.australiansuper.com/DiversificationBasics or AustralianSuper's *Investment Choice Guide*, available at www.australiansuper.com/InvestmentGuide



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