Investing 101: Bonds

Description

Contrary to stocks, bonds are a much safer investment. Bonds fall under the category of fixed income due to payments throughout the term and at maturity. It is a loan from an investor to a borrower whereby the borrowers can be governments or corporations.

Bonds are classified as debt funding as opposed to stocks, which are equity funding. The main components of a bond include the coupon rate, the yield to maturity, the term, and if its trading at a premium, par, or discount.

In Canada, federal and provincial bonds are generally given a AAA rating, which means it is among the highest-quality bonds on the market. Countries such as Venezuela are the complete opposite with the country being rated SD, which means it is not able to make payments to its creditors.

All about bonds

Bonds can differ from each other in a variety of ways. Firstly, bonds can mature from several months to several years. Secondly, bonds are rated from AAA to C/D, which take into account the probability of default and the overall quality of the issuer. Bonds are further divided into senior and junior debt, whereby senior debt has priority over junior debt.

Governments use the money from bonds to fund roads, schools, hospitals, and other infrastructure and can also be used to raise money for war. Examples of this include Government of Canada bonds (currently sold) and War Bonds (sold during WWII).

Corporations also issue bonds to raise money to buy other businesses, assets, acquisitions, and research and development.

The two main factors that influence the bond's coupon rate (the interest payments) are credit quality and time to maturity. An entity's credit quality is inversely related to the coupon rate. The reason forthis being that a higher-credit-quality rating is a greater assurance that the bond will be repaidcompared to a lower-quality rating. This predictability drives down the coupon rate.

Secondly, the shorter the time to maturity, the lower the coupon rate. Bonds with a long maturity dates pay more because the bondholder is more exposed to interest rate and inflation risks for an extended period.

An example

One example of a government bond is the Government of Canada bond. As of August 30, 2019, the yields on one- to three-year bonds are 1.41%; the three- to five-year bonds are 1.25%; the five- to 10-year bonds are 1.17%; and +10-year bonds are 1.39%.

You may have noticed that the 10-year bond's yield is less than the one-year bond's yield. This is widely agreed upon by economists as an indication of a pending recession. When the yield of a short-term bond is higher than a long-term bond, it means that investors are scrambling to purchase more long-term bonds. This drives up the price, which lowers the yield (the compounded percentage change between the current price and maturity price). Essentially, it is not a good sign for the economy in the near future.

Bottom line

Bonds are a much safer investment than stocks, if you choose the right bond. It should be noted that bonds issued by corporations are generally riskier than bonds issued by governments. This is because the probability of the government defaulting is less than a corporation defaulting.

Bonds can be a great investment in an economic downturn and a good choice to complement your portfolio. The process to select bonds should be as careful, as selecting stocks as the strength of the company is dependent on you receiving coupon payments and the face value at maturity.

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