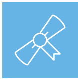
M&G Investments

The M&G guide to Bonds



Contents

Explaining the world of bonds 3

Understanding how bond prices can rise or fall 5

The different types of bonds 8

Bonds compared with other types of investments 10

How can you invest in bonds? 11

A few questions to ask before you invest in a bond fund 12

Glossary 14

The M&G guides 16

Please refer to the glossary found on pages 14 and 15 for an explanation of the words highlighted in **bold** throughout this guide.

Explaining the world of bonds

Bonds can seem complicated at times, but if the idea of a regular income appeals to you, it's worth finding out more about them. If you don't know your **coupon** from your **credit rating** or your **principal** from your **par value**, this guide is designed for you. Our aim is to give you the basics, to help you make informed decisions about your investment aims.

Depending on your situation and your financial goals, investing in bonds could be right for you. But if, after you've read this guide, you think you'd be better suited to something different, there are a variety of other investment options for you to have a look at. These are explained in more detail in our other M&G guides; see page 16 for more details.

So, what are bonds?

- A bond is a loan
- When you buy a bond, you're lending money to the government or company that issued it
- They should give you regular interest payments in return, plus the original amount back at the end of the loan

The value of your investment can go down as well as up so you might not get back the amount you put in.

The name's Bond...

Often referred to as bonds, they're also known as '**fixed income**' or '**fixed interest**' securities. It's likely you'll come across all these terms when you read about investments. They'll describe the same thing, so we'll just call them bonds in this guide.

Understanding the risks

Importantly, there's a chance you won't be repaid your original investment, which is the key **risk** you face when investing in bonds. It's one of the reasons they're considered to be higher risk than just putting your money in a savings account (although bonds are still generally lower risk than investing in company shares, or **equities**).

Where things get a bit more complicated is that bonds can be sold on – just like a company's shares. This means their price can change. We'll explain this in more detail on the next few pages.

Three words you need to know...

Before we go any further, there are three words we need to introduce. They are '**principal**', '**coupon**' and '**maturity**':

- The **principal** is the amount you lend to the government or company issuing the bond
- The **coupon** is the regular interest payment that you receive for buying the bond. It's often a fixed amount that is set when the bond is issued
- **Maturity** is the date when the bond expires and the principal is repaid

Returns from bonds

Income coupons

You know exactly how much you'll receive and when, assuming the issuer doesn't miss payments.

Capital return

If you buy a bond from another investor for less than its original cost, you could make a profit by holding it to maturity.

Understanding how bond prices can rise or fall

If you buy a bond when it's issued, you pay a fixed price. However, after it's issued, you can trade the bond with other investors, much like you can with shares. When you buy or sell a bond in this way, its 'market' price will be affected by a number of factors.

Here we look at the four main influences on bond prices.

1. How interest rates affect bonds

The interest rates paid by banks and building societies normally follow the official interest rate set by the Bank of England. The Bank of England uses this rate as a tool to manage the UK economy.

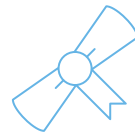
When times are tough, interest rates tend to be cut in the hope this will encourage consumers to spend, businesses to borrow and, through this process, kick start the economy.

If things are going well and consumer spending, as well as bank lending, are starting to look too strong, the prices of goods and services could rise, which is known as inflation. The Bank of England could raise the interest rate to slow inflation down by reducing the demand for borrowing, which in turn would reduce pressure on prices.

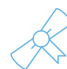
Normally, bond prices tend to move in the opposite direction to interest rates. We can illustrate this with a simple example.

Imagine you had a choice between a savings account that pays interest of 0.5% and a bond that offers you interest of 1.25%. In choosing where to invest your money, you'd have to take into account the higher level of interest paid by the bond and decide whether it is worth the greater level of risk it involves. We'll look at this risk in more detail on pages 8 and 10.

Now imagine that the Bank of England believes that the economy is growing too fast and decides to raise the official interest rate, causing the rate on the savings account to move up as well, to 2%. Suddenly, the 1.25% on the bond doesn't look as appealing, so its price is likely to fall. Equally, if the Bank of England cuts interest rates, the interest on the bond becomes more attractive, so its price may rise. Please note, this isn't a real life example or a recommendation.



0.5% interest | coupon



2.0% interest | coupon

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2. How inflation affects bonds

Things tend to get more expensive over the years. This rise in prices is referred to as **inflation**. When inflation is high, it can be a problem for bonds because the income they pay has normally been fixed at the time of issue.

A bond that offers interest of 5%, for example, may sound good in isolation, but if inflation is running at 4.5%, the real return, or return after adjusting for inflation, is only 0.5%. This means bonds tend to become less attractive (and prices fall) when inflation is rising.

On the other hand, if inflation is falling, a fixed interest of 5% becomes a lot more appealing. Therefore, in a situation where inflation is falling or low, bond prices tend to rise. Please note, this isn't a real life example or a recommendation.

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3. How an issuer's prospects affect bonds

Some companies find it financially easier than others to pay their debts. This ability to repay is measured by their credit rating, or creditworthiness. It's an assessment, carried out by independent rating agencies, of a borrower's ability to repay its debt. A higher rating means a company is very likely to meet its payments.

On the other hand, if a company's financial situation weakens, its credit rating will be downgraded, as there's a greater chance that the company will struggle to make its payments. As a result, its bond price will often fall, as investors decide that the income offered by the bond isn't enough to make up for the fact that it's now riskier.

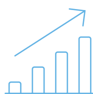
The same is true for governments, which are also given credit ratings by rating agencies. Governments in the developed world, such as the UK or the US, are generally considered to be more likely to meet their payments than governments in some developing countries, and so tend to be given a higher credit rating than the latter. A change in a government's financial health will therefore affect its credit rating and, in turn, the price of its bonds.

4. How supply and demand affects bonds

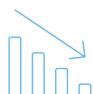
If a lot of companies or governments suddenly need to borrow, there'll be many bonds for investors to choose from, so prices are likely to fall. On the other hand, if more investors want to buy than there are bonds on offer, prices are likely to rise.

What drives the value of bonds up or down?

Value increases:
More investors want to buy, but fewer bondholders want to sell.



Value decreases:
More bondholders want to sell, but fewer investors want to buy.



Are bonds right for you?

A key advantage of investing in bonds is that you could receive a stable income and your original investment back at the end of the loan. There's also the potential for a profit if you sell the bond at a higher price than you paid when you bought it. The value of your investment can go down as well as up so you might not get back the amount you put in.

A stable income

Because the interest is fixed when you buy a bond, you'll generally know exactly how much you'll receive and when it will be paid. If you're relying on your investment for income, the regular interest payments from bonds can make it much easier for you to plan ahead – though there's always a chance the company or government who you've lent your money to will fail to keep up the payments.

Preserving your savings

If you hold your bond for the life of the loan (and nothing goes wrong in the meantime), you should get back what you originally put in. It's as simple as that.

Achieving some growth

As we explained on pages 5 and 6, there are a number of factors that can cause the price of a bond to go up or down. While this rise or fall tends not to be as significant as the changes in price that you see with shares, it could still allow you to make a profit on a bond if you buy and sell it at the right time. Equally, if a bond falls in value and you buy it for less than its original cost, you could hold it to maturity and you'd make a profit in addition to any income you receive. (In both cases, it's also possible to make a loss.)

The value of your income

Because the price of a bond can change, but the income payments are fixed, the return on the bond (often referred to as the yield) can vary. For example, a bond issued at £1 with a 5p coupon, has a yield of 5%. However, if the price rises to £2, the coupon is still 5p, so the **yield** falls to 2.5%. This means that if you're buying bonds from other investors and you need a certain level of income, the price you pay is very important. This isn't a real life example or a recommendation

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- Bonds can be traded like shares
- This means their prices can go up or down, depending on a number of factors
- These factors include interest rates, inflation and the economic outlook
- Bonds normally pay a pre-agreed regular income
- You should then get the initial investment back when the loan expires

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The different types of bonds

Choosing between the different types of bonds

There're many different kinds of bonds in the market, so it's important to know exactly what you want from your investment. In particular, there's one question you need to consider. Are you willing to take on more risk, with the aim of achieving more income, or do you want to keep things as safe as possible? Your answer will help you decide which types of bonds are right for you.

You can lend money to a country (a **government bond**) or to a company (a **corporate bond**).

A higher level of interest normally means a higher level of risk.

Bond issuers are normally graded according to their ability to repay their debt.

The two main **issuers** of bonds are governments and companies:

Government bonds

Government bonds are issued by countries, normally to raise money for public spending. Among the biggest issuers of government bonds are the UK government (UK government bonds are also known as **gilts**), the US government (their bonds are known as **Treasuries**) and the German government (**bunds**).

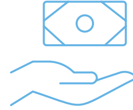
Governments with solid public finances are generally regarded as low risk, as they're less likely to fail to keep up the payments. Therefore, they tend to pay very low coupons, or interest.

Corporate bonds

Corporate bonds are issued by companies when they need to raise money to finance their business, or to repay other loans. They're often considered to be higher risk than government bonds, because companies generally are more likely to have problems paying their debts.

Investment grade bonds

A company or government with a high credit rating is considered to be 'investment grade'. This means you're less likely to lose money on their bonds, but you'll probably get less interest as well.



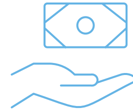
high credit rating

low risk, low yield

High yield bonds

At the other end of the spectrum, a company or government with a low credit rating is considered to be 'high yield'. As the company or government issuing them has a higher risk of failing to meet their repayments, they have to offer a higher level of interest to encourage people to buy their bonds.

While the majority of bonds that are issued pay a fixed level of interest, there are others that pay a flexible rate, or adjust their payments in line with inflation.



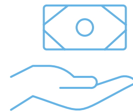
low credit rating

high risk, high yield

Index-linked bonds

As we mentioned on page 6, inflation can be a real problem for bond investors. One possible solution for investors worried about changes in the inflation rate is offered by index-linked bonds.

The value of the loan and the regular income payments you receive are adjusted in line with a particular measure of inflation (in the UK, this is usually the **Retail Prices Index**). This means that when inflation is rising, your coupon payments and the amount you get back will go up in line with the inflation rate, and vice versa.



index linked

varies with inflation

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Bonds compared with other types of investments

Where could you invest?

When it comes to choosing where to invest, the option you go for is likely to depend on how you feel about risk and what you need from your investment.

Cash grows only by the interest rate applied to the savings account. However, it is the most secure home for your money.

Bonds are generally lower risk than equities and provide a regular income, with more growth potential than cash.

Property offers the combination of a long-term income and potential for some capital growth through investing in 'bricks and mortar' assets.

Equities have the potential for strong growth, but also come with the possibility for greater losses.

It's possible to create what's called a '**diversified** portfolio', meaning an investment portfolio that's made up of a combination of some or all of cash, equities, bonds and property. This might offer more stability through the ups and downs in markets and economies, because different types of investments tend to rise or fall at different times and at different rates.

- Cash savings are the safest way to invest, but they also have the least chance to grow
- Bonds offer the potential for a regular income and tend to be lower risk than property and equities
- Equities (also known as shares) are part-ownership of a company, so you have a share in its profits. They're higher risk than property, bonds and cash, but they also offer the greatest potential for growth

How can you invest in bonds?

The different ways you can invest in bonds

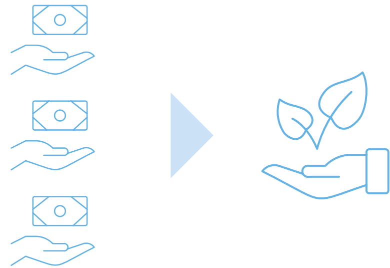
While it's possible for you to buy bonds yourself, it's not the easiest thing to do and it tends to be quite expensive.

An expert's perspective

Investors may find that it's much more straightforward to buy a fund that invests in bonds. This has two main advantages:

1. Your money is combined with investments from lots of other people, which means it can be spread across a range of bonds in a way that you just couldn't do if you were investing on your own. Because of the mix of investments, however, bond funds cannot promise a fixed income over time.
2. Funds are normally managed by professionals who are backed by all the research resources of an investment company. This helps them find the best opportunities and avoid bonds that may have problems down the line; however, there's no guarantee of course that they will be successful. When you take money out and/or when we take a charge this will reduce the value of your investment.

- You can invest directly in bonds
- You can put your money into a fund where the fund manager chooses the bonds
- There are many different types of bond funds to choose from



Pooling your money

You can pool your money with other investors to buy a range of bonds, diversifying your investments to reduce exposure to any one government or company.

An experienced fund manager invests and manages on your behalf. An active manager typically aims to outperform other similar bond funds.

A few questions to ask before you invest in a bond fund

- What sorts of bonds does the fund invest in?
- How does the fund manage risk?
- How does the manager determine which bonds to invest in?

Picking a fund that meets your needs

The names of bond funds can sometimes reveal very little, so it's a good idea to get a sense of the potential risks of a fund by looking at the types of bonds it invests in and what the average credit rating is of its bond holdings. For example, you can choose between funds that invest purely in government bonds, funds that invest in **investment grade corporate bonds,** or funds that invest only in **high yield bonds**, or you could choose a fund able to invest in all the different types.

Checking how the manager produces an income

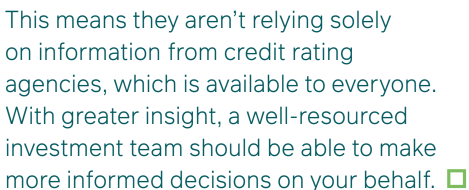
Income on a bond fund is produced by the regular coupons paid by the bonds held in the portfolio. As you probably expect, you have to pay for the management of any bond fund you invest in. The way these charges are handled will affect the total income you get.

Making sure you are happy with the way a fund manages risk

The returns from bonds are primarily influenced by changes in interest rates and the ability of the borrower to repay its debt. Different bonds are affected differently by changes in these two key factors. Before you invest, it's worth making sure the company managing your bond fund has the knowledge, experience and resources to monitor these challenges and make changes whenever they are required.

Finding out how your fund manager's investment company researches opportunities

There are few people who would lend money to someone without knowing anything about them. Investing in bonds is just the same. If your fund manager's investment company has its own team of analysts, they can carry out their own in-depth research into the bonds they might hold.



This means they aren't relying solely on information from credit rating agencies, which is available to everyone. With greater insight, a well-resourced investment team should be able to make more informed decisions on your behalf. □

Glossary of investment terms

The following are explanations of some of the terms you would have come across in this guide.

Bond A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Bunds Fixed income securities issued by the German government.

Capital return The term for the gain or loss derived from an investment over a particular period. Capital return includes capital gain or loss only and excludes income (in the form of interest or dividend payments).

Corporate bonds Fixed income securities issued by a company. They are also known as bonds and can offer higher interest payments than bonds issued by governments as they are often considered more risky.

Coupon The interest paid by the government or company that has raised a loan by selling bonds.

Credit rating An independent assessment of a borrower's ability to repay its debts. A high rating indicates that the credit rating agency considers the issuer to be at low risk of default; likewise, a low rating indicates high risk of default. Standard & Poor's, Fitch and Moody's are the three most prominent credit rating agencies. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Default When a borrower does not maintain interest payments or repay the amount borrowed when due.

Diversified/Diversification The practice of investing in a variety of assets. This is a risk management technique where, in a well-diversified portfolio, any loss from an individual holding should be offset by gains in other holdings, thereby lessening the impact on the overall portfolio.

Equities Shares of ownership in a company.

Face value The initial price of a bond, also known as par value.

Fixed income security A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid. Also referred to as a bond.

Gilts Fixed income securities issued by the UK government.

Government bonds Fixed income securities issued by governments, that normally pay a fixed rate of interest over a given time period, at the end of which the initial investment is repaid.

High yield bonds Fixed income securities issued by companies with a low credit rating from a recognised credit rating agency. They are considered to be at higher risk of default than better quality, ie higher-rated fixed income securities but have the potential for higher rewards. 'Default' means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Inflation The rate of increase in the cost of living. Inflation is usually quoted as an annual percentage, comparing the average price this month with the same month a year earlier.

Inflation-linked bonds/Index-linked bonds Fixed income securities where both the value of the loan and the interest payments are adjusted in line with inflation over the life of the security. Also referred to as index-linked bonds.

Investment grade corporate bonds Fixed income securities issued by a company with a medium or high credit rating from a recognised credit rating agency. They are considered to be at lower risk from default than those issued by companies with lower credit ratings. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Issuer An entity that sells securities, such as fixed income securities and company shares.

Maturity The length of time until the initial investment amount of a fixed income security is due to be repaid to the holder of the security.

Par value The initial price of a bond, also known as face value.

Principal The face value of a fixed income security, which is the amount due back to the investor by the borrower when the security reaches the end of its life.

Retail Prices Index (RPI) A UK inflation index that measures the rate of change of prices for a basket of goods and services in the UK, including mortgage payments and council tax.

Risk The chance that an investment's return will be different to what is expected. Risk includes the possibility of losing some or all of the original investment.

Total return The term for the gain or loss derived from an investment over a particular period. Total return includes income (in the form of interest or dividend payments) and capital gains.

Treasuries Fixed income securities issued by the US government.

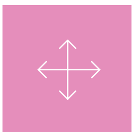
Yield (bonds) This refers to the interest received from a fixed income security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

The M&G guides

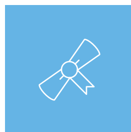
The M&G guides aim to give you the basics about investing, to help you make informed decisions about your financial goals and how to reach them.

We're unable to give financial advice. If you're unsure about the suitability of your investment, speak to a financial adviser. The views expressed in this document should not be taken as a recommendation, advice or forecast.

This brochure is part of our range of M&G guides:



Investing



Bonds

Equities

Risk

Multi-asset investing

Income

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