Product Briefing - Bonds

Although bonds have many different forms this briefing will focus on standard ("vanilla") structures. **In return for borrowing a given sum of money, the issuer of the bond will pay a series of contractual interest payments to the owner of the instrument**.

When bonds were issued in physical form, the owner would detach a small coupon and present this to a bank appointed on behalf of the borrower as their eligibility to receive interest. As a result of this practice, **interest payments on bonds are termed coupons**.

Fixed income bonds are sovereign or corporate IOUs that evidence the indebtedness of a borrower.

At the maturity of the instrument the investor will be repaid the value stated on the face of the bond but this may not be the sum that was originally paid to acquire the asset. This is because **bonds are traded on a price basis**, which is quoted as a percentage of the face value.

Bond prices area a function of their future cash flows and current alternative rates of return. Suffice to say that with a limited amount of any bond in issue, the relative of attractiveness of the fixed coupon will be the key determinant of how much an investor will pay to acquire the bond. If a bond has a fixed coupon of 5% but investors could earn a greater return on an equivalent investment (equivalent in terms of maturity and the risk of default), the bond will have to be priced at less than its face value in order to make the investment attractive.

If it were priced at say 95.00 and the investor held the instrument to maturity, they would be repaid 100% of the face value and would enjoy a capital gain of just over 5% over the period. The opposite would be true for a bond that has a relatively attractive coupon. Through the interaction of demand and supply, investors will seek to possess the bond, which will drive up its price. If held to maturity the investor will incur a capital loss but will have earned an above market interest rate. The market uses the concept of a yield to capture the overall return to an investor. At a simple level **a yield will reflect any capital gain or loss from holding the bond to maturity in addition to the receipt of any coupon**.

One of the key concerns to a buyer of a bond is the ability (or willingness) of the issuer to repay their debts. This is **credit risk, which is the risk that money owed will never be repaid**. If there are concerns over the issuer's ability to repay coupon or principal the yield should increase to reflect this risk.

Example of fixed coupon bond