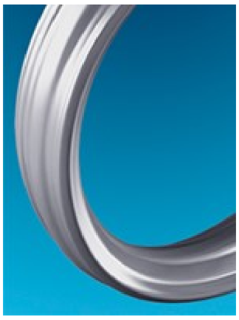
Perpetual

WHAT ARE BONDS?



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We're not talking about the underwear brand, nor the attraction of atoms …and not that overwhelming, unbreakable bond you have with your child (…or pet). We're talking a slower, steadier way to make a return (disclaimer: like any investment, bonds carry some risk but generally less than the investing in the sharemarket).

Yes, we're talking financial bonds. What fun.

A bond is a type of I owe you (IOU): whoever issues the bond is borrowing the money from the buyer of the bond. In return, the bond issuer agrees to pay the bondholder back on a specific day in the future, as well as give regular interest payments along the way (these regular payments are also why bonds can also be referred to as 'fixed income' investments). Pretty much, when you invest in a bond, you are effectively lending money to a government or company at an agreed interest rate for a set period of time. And in return the borrower promises to pay you an agreed interest rate for a set period of time.

And now an IOU - a breakdown of how bonds work

Bonds have a face value which is the amount you will get back at maturity (that is, the date in which interest payments must be paid in full) and a coupon amount which is the interest paid each year. This amount could be divided into half-yearly or quarterly amounts.

Which sounds simple right?

Right, but generally only if you buy a bond at the start of the term and hold it to maturity or the end of your set period of time. Things get more complicated if you only hold a bond for part of the term. Bonds that you can trade on a secondary market (the most common being the Australian Stock Exchange or ASX) are known as 'listed' or 'exchange-traded' bonds. Listed or exchange-traded bonds give you the flexibility to sell the investment if your circumstances change (or you're a bit of a commitment-phobe).

How do bonds differ from shares?

Shares (also known as stocks or equities) like bonds are an investment. The key difference between the two is the fact that shares are not loans. Rather, shares represent part ownership in a company and the return you receive is the share in profits the company makes. For this reason, shares are generally considered riskier and more volatile investments. Typically, bonds have a fixed interest rate (or return). In saying this, there are 'floating-rate bonds' whereby interest rates adjust depending on market conditions.

Like shares, **bonds** can also be traded. When someone sells a bond at a price lower than the amount paid to the holder at maturity (face value), it is said to be selling at a discount. If it is sold at a higher price than the face value, it's selling at a premium.

So why do bonds exist?

Businesses, and even governments often need loans to fund significant projects, operations or to move into new markets, innovate and grow. Often this amount of money will surpass the amount a bank can provide. So, businesses and governments issue bonds to raise the necessary funds. It's basically just a huge loan and when you buy a bond, you're effectively lending money to the business or government that is issuing it.

So, how safe are bonds as an investment?

Bonds range from rather safe (such as Australian Government bonds) through to very risky (some businesses that are unlikely to repay your money). It's very important to know what you're investing in as not all bonds (or fixed interest investments) are the same.

In general, bonds are less volatile and risky than other investments such as property or shares. However, losses are possible if interest rates change or bond issuers default (fail to repay) on the obligations to bondholders.

It's best to ask a licensed financial adviser about the quality of a bond you are considering to invest in.