Bonds Overview - An Introduction to Bonds

Welcome to this first Academy module on Bonds. In this module you’ll learn about:

- A brief introduction to the history of bonds
- What Bonds are and how they work
- Who issues Bonds and why.

We’ll also take you through the key terminology and phrases used when trading bonds.

Hopefully this course will act as a springboard to further learning and lead to you making smarter, more informed investments.

So let’s get going.

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So, What is a Bond?

In essence, a bond is simply an “I Owe You” (IOU), where the borrower – called the issuer – borrows money from a lender – the investor.

So A company needs to borrow USD500 million. They therefore issue a bond. Investors ‘buy’ the bond, thereby loaning money to the issuer.

Governments, public entities and companies typically issue bonds. As a financial instrument, they have been around for millennia.

The main reason why an issuer will choose to issue a bond – rather than borrow the money directly from a bank – is that the amount the issuer needs to borrow is larger than the amount they could borrow from a single bank. So the issuer borrows the money by issuing a bond. With a bond, multiple investors each lend the issuer a fraction of the total issued amount. Also, for many large corporates, it makes sense to borrow directly from investors, instead of a bank. It is both cheaper and more efficient.

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What's the Difference between a Bond and an IOU?

A key difference between an IOU between two individuals and a bond is that the bond is transferable and has some standardized definitions and terminologies. These enable the bond to be traded easily between investors after it has been issued.

If you take out a mortgage, you pay interest to the bank on top of your loan amount. And, borrowing money by issuing a bond also doesn't come free. The issuer will pay interest on the bond – also known as the coupon – at fixed intervals to the investor.

Furthermore, a bond also has a date at which the amount borrowed will be paid back to the investor. This date is known as the maturity date.

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Who or what issues Bonds and Why?

Many companies that issue bonds have also issued stocks – also known as shares. A key difference between stocks and bonds is that bonds are debt whereas stocks are equity.

The implications of this difference are as follows:
As a bond investor, you become a creditor to the issuer. This means that you would have a higher claim on the issuer's assets than stockholders would. So, in case of bankruptcy, the bondholders would receive payment before the stockholders.

Because bondholders are simply creditors to the issuer, they don't have voting rights – unlike stockholders. Neither do bond holders have the right to receive any dividends paid by the issuer to the stockholders.

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Bondholders vs Stockholders

Bondholders are in a better position than the stockholders in case of bankruptcy. But they don't have the upside potential that stockholders have in the event that the issuer performs better than expected by the market. These include being able to sell the stock at a higher price than it was bought for and being able to receive dividends from the issuer.

Even though bondholders are in a better position relative to stockholders, the price of a bond is also influenced by the credit worthiness of the issuer. If the credit worthiness of the issuer goes up, then the price of the issued bonds will – everything else being equal – also go up. If the credit worthiness goes down, the price will go down.

We take a closer look at credit worthiness in another course.

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Bonds: The Basics

Let’s quickly summarize some of the basic concepts of Bonds.

- ✓ Bonds have existed as a means to raise money for thousands of years. In essence, Bonds are an IOU that can be traded between investors.
- ✓ Bonds can be viewed as a safer investment than Stocks because they have a higher claim in the case of bankruptcy on the issuer.
- ✓ Bond investors don’t have the same upside potential as Stock investors. Neither do Bond investors have the right to receive stock dividends.
- ✓ Issuers of Bonds pay interest - known as coupon - at fixed intervals. And they repay the borrowed amount at a predefined date. Known as the maturity date.
- ✓ The creditworthiness of the issuer can influence the price of a Bond. If the creditworthiness of the issuer increases, the Bond price - everything else being equal - will go up... and vice versa.

We hope you enjoyed this course.

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Bonds – Some Key Terminology

Over the next few pages we'll explore some of the key phrases and terms used in Bond trading. You'll learn about:

- Bond issuers
- The investor
- Face value
- Interest / Coupon
- Yield to maturity
- Repayment
- Where Bonds are traded

These key terms and phrases are simply a starting point and will give you a solid foundation from which to build on. So let's take a look.

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Bonds – Some Key Terminology

Key Terminology: Issuers

As we know, a bond is a debt investment in which INVESTOR lends money to an entity that borrows the funds for a defined period of time at an interest rate paid at predefined intervals.

So who issues them? The ISSUER is the entity that borrows the money by issuing a Bond. Issuers are typically divided into categories that are defined by their governance structure.

Key Terminology: The Investor

The **INVESTOR** is the person or entity buying the Bond. He or she pays a price when buying the bond and receives interest at predefined intervals. If the INVESTOR holds the Bond until it expires, they will also receive the invested nominal value at maturity

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Key Terminology: Face Value

The Bond principal is also referred to as the ‘face value’ or ‘par value’. It is the amount that the investor will get back when the bond matures.

Typically Bonds are issued with a minimum total principal amount of 1,000 million Khmer Riel or 500 million Khmer Riel for secured bonds. Some large corporations can be issued Bonds with a principal amount of more than 1,000 million Khmer Riel.

Key Terminology: Interest / Coupon

Interest is also known as the coupon. This term defines the rate of interest that is paid on the bond by the borrower.

The most common types of interest are fixed or floating. A bond with a fixed coupon pays the same rate of interest throughout its life at fixed intervals, typically once a year or semi-annually.

A Bond with a floating coupon typically pays a fixed rate of interest that is on top of a benchmark interest rate, for example, the three-month Libor rate. As a result, the coupon is set to be paid at predefined intervals – for example every three or six months.

Key Terminology: Yield to Maturity

The yield to maturity expresses the return that the **INVESTOR** gets on the Bond investment if it is held to maturity. It is shown as a percentage.

The yield to maturity equals all the interest payments the investor will receive plus any gain or loss between the price the Bond was bought at and the repayment price, which is usually 100. The formula assumes that the **INVESTOR** will re-invest future coupon payments at the same rate as the current yield on the bond.

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Key Terminology: Repayment

Repayment, also known as the instalment of the Bond, can be made in various ways. The most commonly used is the ‘bullet-type’ repayment, which applies to 90% of all issued Bonds. With bullet-type bonds, the principal is paid back in one amount at maturity.

Key Terminology: Where are Bonds Traded?

Bonds are either traded via an exchange or over the counter, which is also known as ‘OTC’. Bonds are usually listed on an exchange but, unlike equities, their liquidity is poor so the trading is done OTC.

In a later chapter, we’ll take a closer look at how bonds are traded OTC.

Summary

So let's review what we learnt on the course:

- ✓ Bonds are debt instruments where the issuer borrows money from the investor who buys the Bond.
- ✓ The issuer pays the investor interest, also known as a coupon, for borrowing the money. The coupon is typically paid annually or semi-annually and can be fixed for the entire life of the bond - or it can float, meaning that the amount of the coupon varies.
- ✓ There are various types of issuers, ranging from supra-nationals to corporations.
- ✓ The total amount of a Bond issued is called the principal. In 90% of all cases, this is repaid in one amount at the maturity date in a 'bullet-type' repayment.
- ✓ The investor's return on the bond is termed the 'yield to maturity'. It defines the total return – in percentage terms – that the investor earns on the investment if they hold it to maturity. This is not to be confused with the interest or coupon paid on the bond. The coupon is the agreed interest paid at predefined intervals on the bond by the issuer.