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Guide to bonds and fixed interest funds

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Introduction

As an investor, you can choose from a wide variety of investments, offering different types of returns and levels of risk. Broadly speaking, the major types of investment, or asset class, are: equities; fixed interest (also known as bonds) and property. You can choose to invest in these directly or via a pooled investment vehicle, such as a fund. This is a guide to bonds and fixed interest funds, which was written with the kind help of M&G Investments.

What are bonds?

Bonds can seem complicated at times - particularly as they can also be referred to as fixed interest/ income securities – but if the idea of a regular income appeals to you, it's worth finding out more about them.

In simple terms, a bond is loan. When you buy a bond you are lending money to the government or company that issued it. In return for the loan, they will give you regular interest payments, plus the original amount back at the end of the term.

As with any loan, there is always the risk that the company or government won't pay you back your original investment, or that they will fail to keep up their interest payments (default).

There are three key words that are useful to know, when it comes to bonds: principal; coupon and maturity.

- The principal is the amount you lend the company or government issuing the bond
- The coupon is the regular interest payment you receive for buying the bond. It is often a fixed amount that is set when the bond is issued and is also referred to as 'income/yield'
- The maturity is the date when the loan expires and the principal is repaid

Understanding how bond prices can rise or fall

Where things get a bit more complicated is that bonds can be sold on and traded – just like a company's shares. This means that their price can go up and down, depending on a number of factors. The four main influences on bond prices are: interest rates; inflation; issuer outlook and supply and demand.

Interest rates: Normally, bond prices tend to move in the opposite direction to interest rates. To illustrate this, imagine you have a choice between a savings account that pays 0.5% and a bond that offers interest of 1.25%. You may decide the bond is more attractive. However, if the Bank of England raises interest rates and banks follow suit, the savings account may now offer 2%. Suddenly the 1.25% the bond is paying isn't so appealing and its price is likely to fall.

Inflation: Because the income paid by bonds is usually fixed at the time they are issued, high or rising inflation can be a problem, as it erodes the real return you receive. As an example, a bond paying interest of 5% 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%. However, if inflation is falling, the bond may be even more appealing.

Issuer outlook: As a company's or government's fortunes can either worsen or improve, the price of a bond may rise or fall as a result of their prospects.

Supply and demand: If a lot of companies or governments suddenly need to borrow, there will be many bonds for investors to choose from, so prices are likely to fall. Equally, if more investors want to buy than there are bonds on offer, prices are likely to rise.

The different types of bond

There are two main issuers of bonds: governments and companies.

Bond issuers are normally graded according to their ability to repay their debt i.e. their credit worthiness.

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

At the other end of the spectrum, a company or government with a low credit rating is considered to be 'high yield'. As the issuer has a higher risk of failing to repay their loan, the interest paid is usually higher too, to encourage people to buy their bonds.

As mentioned previously, inflation can be a problem for bond investors. One solution is index-linked bonds. The value of the loan of these bonds, and the regular income payments you receive, are adjusted in line with inflation. This means that if inflation rises, your coupon payments and the amount you will get back go up too and vice versa.

Fixed interest funds

While it is possible for you to buy bonds yourself, it's not the easiest thing to do and it tends to require a lot of research into reports and accounts and be quite expensive.

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

Firstly, 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 if you were investing on your own.

Secondly, professionals are researching the entire bond market on your behalf.

However, despite the name, because of the mix of investments, fixed interest funds do not always promise a fixed level of income, so the interest you receive may vary.

If you do invest in a fixed interest fund, make sure you fully understand the type of bond in which the fund will invest and make sure that the level of risk is appropriate.

There are thousands of fixed interest funds available in the UK, so choosing a fund can be a difficult and daunting task. That's why we started FundCalibre and our Elite Fund ratings.

Our experienced research team analyses funds and identifies those which they believe have the most skilful managers. These funds are awarded our proprietary Elite Fund rating. This rating should in no way be construed as advice. It is solely our opinion.

You can use FundCalibre to narrow down your choices and help you select a fund in which to invest. Visit our website: www.fundcalibre.com to find out more. If you require individual investment guidance you should seek expert advice.

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