EVERGREEN ESSENTIALS

BONDS AND INTEREST RATES

The Rundown on Bonds

Bonds are issued by governments and businesses alike, as a way of borrowing money.

When an investor buys a bond, they receive interest in the form of 'coupons', at a rate which is fixed for the life of the bond. Bonds have a maturity date, when the bond amount is repaid to the investor. Investors can also sell bonds to other investors.

Where Interest Rates Come In

If interest rates rise, newly issued bonds will pay a higher coupon to reflect this. However, bonds issued prior still pay the same coupon as before, making these bonds less attractive. This means if an investor wants to sell a previously issued bond, they will need to lower the price, so that it is equally attractive to investors as a newly issued bond.

The reverse is also true. If interest rates drop, the prices of existing bonds will rise as they will pay higher coupons than newly issued bonds.

To demonstrate, our investor, John, is looking to invest $10,000 in government bonds.

John's portfolio currently consists of mostly high-risk tech stocks and he understands that government bonds are a safe, but low return investment.

John can either buy a newly issued government bond or buy one that has already been issued from another investor. The previously issued bond pays the investor a 2% coupon.

For our first scenario, the current interest rate is 2% and this means a newly issued bond also pays a 2% coupon.

When the interest rate is the same on both of these bonds, both provide the same annual income. They are effectively identical, so investors will pay the same price for either.

SCENARIO A

2% INTEREST RATE

INVESTMENT	VALUE	YIELD	ANNUAL INCOME	REDEMPTION VALUE	YEARS UNTIL MATURITY
EXISTING BOND	**$10,000**	2.00%	**$200**	$10,000	10
NEWLY ISSUED BOND	**$10,000**	2.00%	**$200**	$10,000	10

SCENARIO B

3% INTEREST RATE

INVESTMENT	VALUE	YIELD	ANNUAL INCOME	REDEMPTION VALUE	YEARS UNTIL MATURITY
EXISTING BOND	**$9,147**	2.00%	**$200**	$10,000	10
NEWLY ISSUED BOND	**$10,000**	3.00%	**$300**	$10,000	10

In Scenario B, interest rates have risen to 3%.

As mentioned earlier, the interest rate on a bond is fixed once it is issued. This means that the existing bond still offers an annual 2% coupon, while the newly issued bond carries a 3% coupon. As a result, John, like other investors, would only be willing to buy the existing bond at a price that means it yields 3%.

If John were to buy a bond before an interest rate increase and sell his bond when rates are higher, he would need to sell it at a lower price than what he bought it for.

SCENARIO C

1% INTEREST RATE

INVESTMENT	VALUE	YIELD	ANNUAL INCOME	REDEMPTION VALUE	YEARS UNTIL MATURITY
EXISTING BOND	**$10,947**	2.00%	**$200**	$10,000	10
NEWLY ISSUED BOND	**$10,000**	1.00%	**$300**	$10,000	10

In Scenario 3, interest rates have dropped by 1%. This causes the opposite to Scenario B to happen. The rate on the previously issued bond becomes more attractive to investors, causing it to increase in value.

What This Means for Investors

The relationship between interest rates and bond prices means that movements in interest rates are a source of risk for fixed income investors.

The measure of how much a bond's price changes with interest rate changes is called 'duration'. All bonds and bond funds have duration. A high duration means the investment carries more interest rate risk, or its price will fluctuate more significantly according to changes in the interest rate.

The Exception

Some bonds have coupon rates that aren't fixed and change with interest rates. These are called floating rate bonds, which do not hold the same duration characteristics as fixed rate bonds.

The Takeaway

The relationship between bond prices and interest rates is crucial in managing risk in your portfolio, but it is by no means the only thing to consider.

It's also important to remember that the risk of an individual asset is less of a concern if it tends to move in a different direction to the rest of your portfolio, as this can provide diversification to the portfolio as a whole.

Ultimately you should discuss with your financial advisor about how relevant this is to you and your strategy.

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