Expert's Quote

Investors are going to look for capital protection, they are sick of all the hot shot advice to make money out of stocks. Capital protection remains the global objective as I see it. This is not protection from the eroding effect of inflation but from total loss of capital in unstable markets… Clive Roffey

NSE at a glance
(For week ended March 30th, 2009)

Index:	31,357.24	-2.04%
Cap:	N6.936trn	-2.04%
Volume:	191.9 m	+10.43%
Value:	N1.29bn	-14.8%

The Risks of Bond Investing

If you asked most people what they feared most about investing, "RISK" is the reply that a good number give. In other words, they want an absolutely risk-free investment environment. The average investor wants a completely risk-less investment option, where he would simply commit his funds, go on a trip, go holidaying, or whatever else catches his fancy, then return anytime and have both capital and returns intact.

This naturally leads to the question: Is there any such thing as risk-free investment? Of course the answer is a capital NO. All investments carry risks. The only difference is in the kind and degree. Even a standard savings account is not risk-free; if the inflation rate exceeds the interest you have earned, you will have lost purchasing power. This typifies the prevailing situation in Nigeria where average savings deposit rate is 3% and inflation rate 12.6%.

If the bank goes down, you run the risk of losing most of your money because unless you are a small saver having below N100,000 as that is the sum guaranteed by the NDIC. Even at that, you would have to wait sometime before getting your money.

Last week, we began the series on Bonds and gave a general overview of what they are. This week, we are moving into specifics by helping prospective bondholders realized some of the risk inherent in bond investing.

So, there is no such thing as a sure thing, particularly so when it comes to investing. Even in the bond world.

No doubt, Bonds are among the safest investments in the world. But that hardly means that they're risk free. Here's a look at some of the risks inherent in fixed-income investing.

1. **Interest Rate Risk**

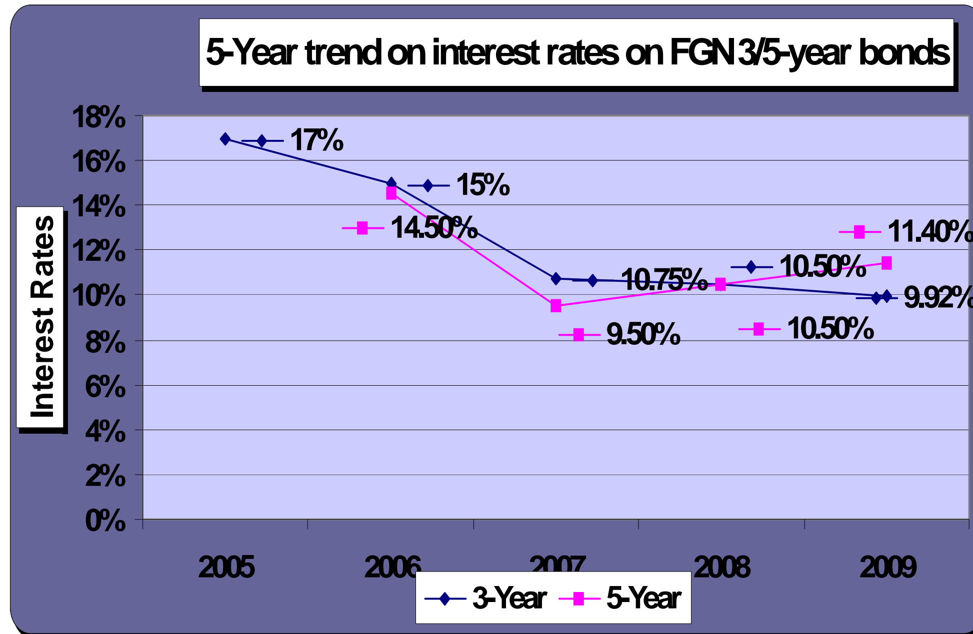
The most well-known risk in the bond market is interest rate risk – This is the risk that bond prices will fall as interest rates rise. By buying a bond, the bondholder has committed to receiving a fixed rate of return for a fixed period. Should the market interest rate rise from the date of the bond's purchase, the bond's price will fall accordingly. The bond will then be trading at a discount to reflect the lower return that an investor will make on the bond.

Market interest rates are a function of several factors such as the demand for, and supply of, money in the economy, the inflation rate, the stage that the business cycle is in as well as the government's monetary and fiscal policies. Therefore if prevailing interest rates rises within the duration of the bond, the bondholder would be getting lower than he should at that period because the interest rate on bonds are fixed from the beginning.

2. **Risk of Default**

A bond is nothing more than a promise to repay the debt holder. Default risk describes the danger that a bond issuer will become insolvent and unable to honor its debt obligations. Although bondholders get priority over stockholders if a company is being liquidated because a bond is a debt, it is still possible to get stuck holding a bond that is worth less than face value even upon maturity.

Default risk is lowest for government-backed securities and highest for below-investment-grade securities known as junk bonds.



There are two things to remember about default risk.

First, you don't need to weigh the risk yourself. Credit ratings agencies do that. In fact, bond credit ratings are nothing more than a default scale. Junk bonds, which have the highest default risk, are at the bottom of the scale. Aaa rated corporate debt, where default is seen as extremely unlikely, is at the top.

> It is pertinent to state however that the risk of bonds varies with maturity because the possibility of gains and losses varies with the length of time interest and principal payments are exposed to market rate fluctuations. Investors should keep their bond terms short because long-term bonds offer little extra return for taking on a higher interest-rate risk and long-term bonds have a larger decrease in price in a rising interest rate environment.

Second, if you're buying government bond, your default risk is nonexistent. The bond issues sold by the Debt Management Office are guaranteed by the full faith and credit of the federal government. It's inconceivable that the people who actually control the money will default on their debt.

3. **Call Risk**

One of the most difficult risks for investors to understand is that posed by "call" provisions in a bond. If the bond's indenture (the legal document that spells out its terms and conditions) contains a "call" provision, the issuer retains the right to redeem the debt, fully or partially, before the scheduled maturity date. For the issuer, the chief benefit of such a feature is that it permits the issuer to replace outstanding debt with a lower-interest-cost new issue.

A call feature creates uncertainty as to whether the bond will remain outstanding until its maturity date. Investors risk losing a bond paying a higher rate of interest when rates have declined and issuers decide to call in their bonds. When a bond is called, the investor must usually reinvest in securities with lower yields. Calls also tend to limit the appreciation in a bond's price that could be expected when interest rates start to slip.

Because a call feature puts the investor at a disadvantage, callable bonds carry higher yields than non-callable bonds, but higher yield alone is often not enough to induce investors to buy them. As further inducement, the issuer often sets the call price (the price investors must be paid if their bonds are called) higher than the principal (face) value of the issue. The difference between the call price and principal is the call premium.

Generally, bondholders do have some protection against calls. An example would be a bond that has a 10-year final maturity, non-call two years. This means the investor is protected from a call for two years, after which time the issuer has the right to call the bonds.

4. **Reinvestment Risk**

Reinvestment risk is related to the fact that we don't have a clue about where future interest rates will be. Not even one of the best-informed financial analysts can tell with absolute certainty where rates are going to be the very next day. Any projection is merely their best guess.

With reinvestment risk in bonds, investors face the possibility that when your bond matures, interest rates could have fallen well below the where they were when they originally bought the bond. If rates are lower when you reinvest the principal you receive back at maturity, the new bond you invest in will provide less income unless you take more risk. This is especially dire for people living on this income.

For example, if you bought N1million value of the 5-year FGN issued in 2003 at the rate of 18.25% your interest would be N182,500 per annum. However, reinvestment of the principal (N1 million) after maturity in 2008 would attract 9.45% thus the income earned on reinvestment of same principal after five years have reduced from N182,500 to N94,500 per annum.

5. **Purchasing Power Risk**

This is the risk that unexpected changes in consumer prices will alter severely a bondholder's real return from holding a bond. Because investments from gold to bonds and stock are priced to include expected inflation rates, it is the unexpected changes that produce this risk. Fixed income securities, such as bonds and preferred stock, subject investors to the greatest amount of purchasing power risk since their payments are set at the time of issue and remain unchanged regardless of the inflation rate.

6. **Inflation Risk**

The risk that the rate of price increases in the economy deteriorates the returns associated with the bond. This has the greatest effect on fixed bonds, which have a set interest rate from inception. For example, if an investor purchases a 5% fixed bond and then inflation rises to 10% a year, the bondholder will lose money on the investment because the purchasing power of the proceeds has been greatly diminished. The interest rates of floating-rate bonds (floaters) are adjusted periodically to match inflation rates, limiting investors' exposure to inflation risk.

Conclusion

It is pertinent to state however that the risk of bonds varies with maturity because the possibility of gains and losses varies with the length of time interest and principal payments are exposed to market rate fluctuations.

Because the value of the remaining stream of payments varies with changes in interest rates, longer maturity bonds fluctuates more than shorter maturity bonds for a given change in rates.

This fluctuation is measured by duration, a more precise calculation of the "effective life" of an investment. Compared to maturity, which only deals with the date when the principal is finally repaid, duration also reflects the amount and frequency of all payments, as well as today's price. Duration is an estimate of a bond or bond fund's sensitivity to interest rate changes.

Investors should keep their bond terms short because long-term bonds offer little extra return for taking on a higher interest-rate risk and long-term bonds have a larger decrease in price in a rising interest rate environment.