Schroders

July 2023

An investor's guide to bonds and fixed income

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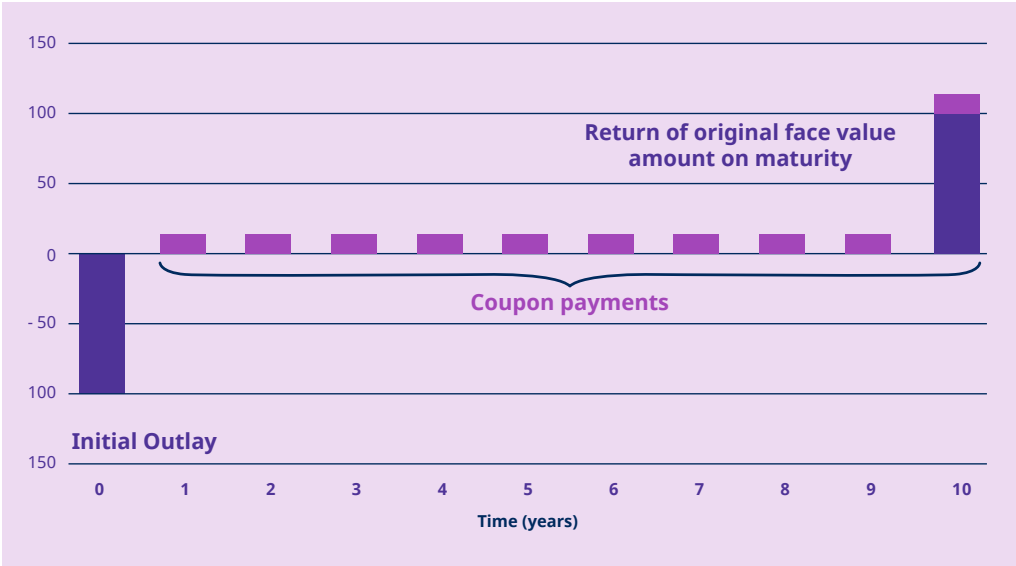
How fixed income works

This short guide explains how fixed income securities (or bonds as they are also known) work and how they can fit into your portfolio. It aims to provide you with a better understanding of why fixed income is an important asset for preserving capital and achieving a steady income. We will use the terms fixed income and bonds interchangeably throughout the document.



What is a bond?

One way a government or a company can borrow the money they need to fund their projects or initiatives is to issue bonds.

The word 'bond' means contract, agreement or guarantee. Each of these terms applies to the financial securities known as bonds, which are simply agreements to borrow money and then repay it (in addition to regular interest payments) after a fixed term.

In other words, a bond is a loan issued by the borrower (issuer) and purchased by the lender (investor). The borrower in turn makes two key promises to the lender:

1. **To repay the capital on a predetermined date (known as 'maturity')**

2. **To pay regular interest payments throughout the life of the loan (at the 'coupon' rate).**

Looking at the payment structure outlined in the diagram above, you can see why bonds are also referred to as 'fixed income' securities. They provide investors with a return in the form of fixed regular payments (coupon) and the repayment of the principal (initial investment) on maturity.

So far, we have discussed the **primary markets** for bonds, where new bonds are created (issued) and bought by investors. Once they have been issued, investors can buy and sell bonds on the **secondary market**. However they are generally not traded on an exchange (like shares) and are bought/sold over the counter (OTC) with high minimum investment thresholds (typically $500,000). This means the typical investor usually accesses bonds via a professionally managed investment fund.

Characteristics of fixed income

An overview of the fixed income asset class

Fixed income is an asset class that tends to be used in the defensive part of investors' portfolios. The asset class primarily consists of debt securities, which are financial assets created when one party lends money to another.

Types of debt securities include government bonds, municipal bonds, corporate bonds and asset-backed securities such as mortgage-backed bonds.

Fixed income investing can potentially offer investors benefits such as assets with a focus on capital preservation, income generation and diversification. Government bonds are also highly liquid, meaning they can be sold for cash quickly and at low cost.

The pros and cons of investing in bonds

Bonds provide a steady income stream and can be a useful alternative to term deposits. But like any other investment, there are both pros and cons to consider before you decide to invest.

Advantages

Security – Bonds provide a degree of certainty that the full principal will be repaid at maturity – although there is no guarantee that will happen.

Regular income – For investors who need a predictable source of income, such as retirees, a bond's regular interest payment can provide greater certainty than other investments.

Performance - A better interest rate may be available from some bonds, such as corporate bonds, than from other investments (like term deposits).

Diversification – Because bonds tend not to move in tandem with stocks, they help provide diversification in an investor's portfolio.

Drawbacks

Credit risk – The risk that a bond's issuer will fail to make interest payments or repay the full principal at maturity.

Market risk – The risk that a bond's value will fluctuate with changing market conditions.

Interest rate risk – The risk that a bond's price will fall because of rising interest rates.

Inflation risk – The risk that a bond's total return will not outpace inflation.

Liquidity risk – The risk that it may be difficult to sell a bond quickly and easily in the market, without incurring excessive costs.

The Risk Spectrum - higher yield for higher risk

Yields on underlying Schroder allocations in the form of unit trusts and sub-portfolios.

Source: Schroders/BRS Aladdin, July 2023.

Types of bonds

Bonds come in all shapes and sizes, and the investment universe for this asset class is large and diverse. That's because different bonds perform differently throughout the economic cycle.

For example, during a period of economic downturn, government bonds tend to outperform as investors seek safety in lower-risk issuers and interest rates fall. On the other hand, during a period of economic recovery, corporate bonds (particularly high yield) will tend to outperform as credit risk improves as the borrower's capacity and ability to repay improve.

Government bonds

Issued by a national government, denominated in the country's own currency, such as Australian Commonwealth Government Bonds and US Treasuries. Government bonds are usually referred to as risk-free bonds with very low credit risk and are among the safest investments available.

Corporate bonds

Issued by companies to raise money for business purposes, such as expanding operations or funding new business ventures. Corporate bonds usually pay higher rates than government bonds because they tend to be riskier – that's because companies, unlike governments, can go out of business and fail to repay.

Semi-government bonds

Issued by state or local governments to fund infrastructure projects and other ongoing financial commitments.

Hybrids

These securities exhibit characteristics of both fixed income investments and equities. Typically, they provide higher yields but also have higher risk associated.

Inflation-linked bonds

The interest rate on these bonds is adjusted on a regular basis to reflect changes in inflation, thereby providing a real or inflation-adjusted return.

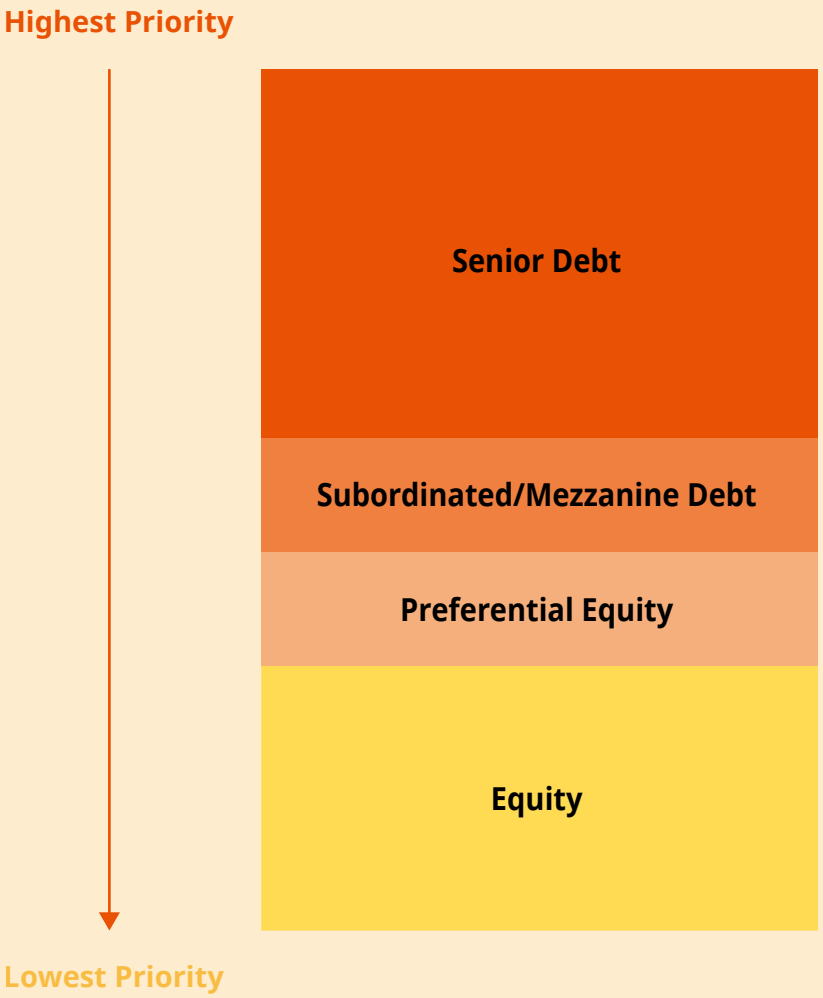
Asset-backed securities

These are bonds created from a collection or pool of car payments, credit card payments or other loans.

Mortgage-backed securities

These are securities created from a pool of residential mortgages and typically pay a floating interest rate on a quarterly basis. Mortgage-backed securities also tend to prepay capital over the life of the security as homeowners pay principal early.

Corporate capital structure



Corporations have a 'capital structure' that determines which stakeholders are prioritised in the event of a liquidation. As you can see from the chart to the left, holders of senior secured debt are the first in the 'queue' to be repaid their money – whereas equity holders will receive any residual value once all the investors with higher priority (seniority) have been repaid.

Performance over the longer term

Typically, a bond with a longer maturity will pay a higher interest rate than a shorter-term bond. For example, 30-year US Treasury bonds often pay one or two percentage points more interest than five-year Treasury notes.

This is because a longer-term bond carries greater uncertainty to potential risks that could reduce the value of payments such as inflation or overall level of interest rates in the future. Bonds with maturities of one-to-10 years are sufficient for most long-term investors. They yield more than shorter-term bonds and are less volatile than longer-term issues.

Key bond concepts

Duration

A bond's price fluctuates in relation to changes in interest rates. Stated in years, duration refers to the approximate change in the price of a bond, given a change in interest rates. For example, a two-year duration means that if interest rates increase by 1%, the bond will decrease in value by 2%. Vice versa, if interest rates fall by 1%, the bond will increase in value by 2%.

Yield

Put simply, yield is a measure of return available from a bond. For example, a 10-year bond with a par value of $100 which pays out a 5% coupon rate (i.e. $5) each year would yield 5%. A familiar example is the rental yield you receive on an investment property.

Credit/default risk

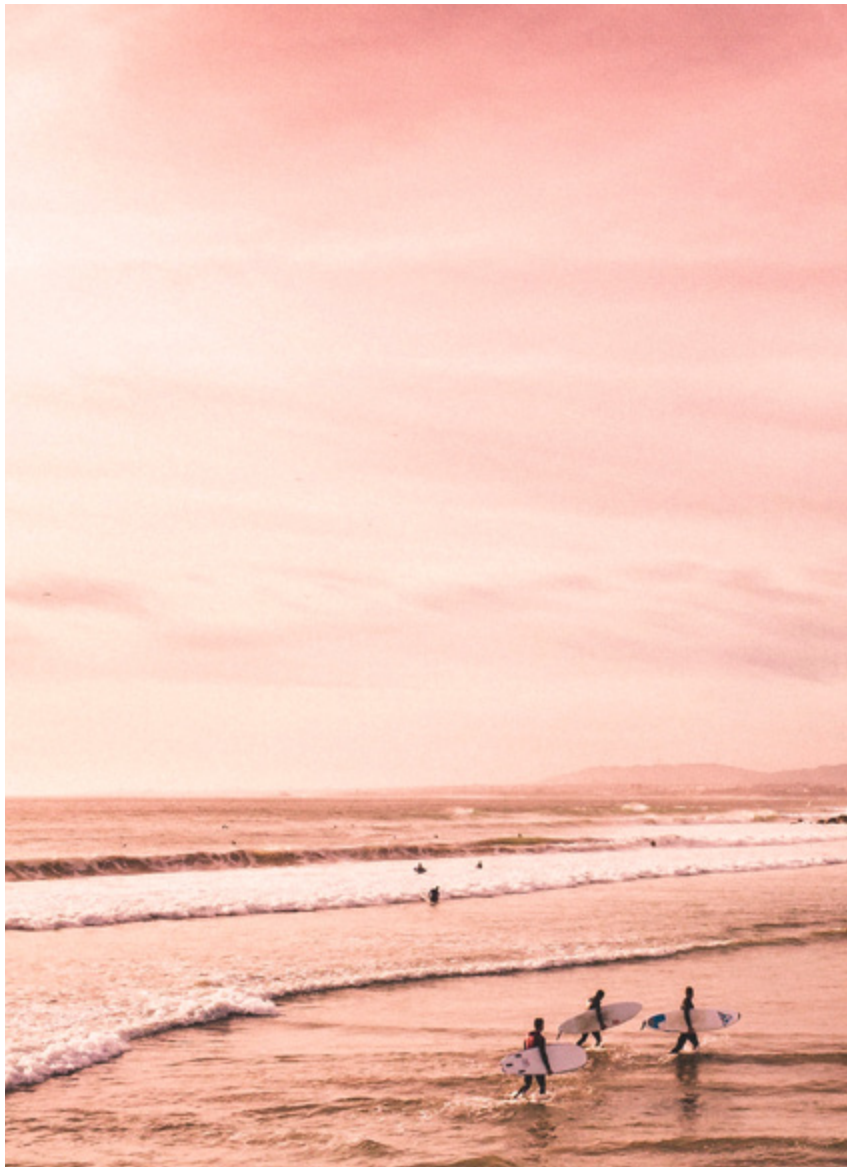
This is the risk that a bond issuer will default, meaning the issuer will be unable to make interest or principal payments when they are due. Bonds issued by government or government agencies or government-sponsored enterprises are less likely to suffer from default due to their ability to raise taxes (as well as issue new bonds). In comparison, bonds issued by corporations, particularly high yield bonds, have a higher probability of default.

Liquidity

Liquidity, or market liquidity, describes how easily an asset, such as a bond, can be bought or sold in the market without affecting its price. When there's high demand for an asset, there's high liquidity, as it will be easier to find a buyer (or seller) for that asset.

Interest rates

The rate charged by a lender of money or credit to a borrower is the interest rate. From the borrower's point of view, it is the cost of borrowing, and from the lender's point of view it is the reward for lending. A bond's interest rate is calculated in relation to current interest rates and the perceived risk of the issuer.



Using fixed income in a portfolio

How to invest in fixed income

You can access bonds directly or through a managed fund. As mentioned earlier, the high minimum purchase amount (typically $500,000) prevents many individual investors from participating directly in the bond market, but bond funds are far more accessible.

The benefit of a managed fund is that it can hold hundreds of securities which allows it to achieve significantly higher diversification than most individual investors. This means that if there is a default on one security, the impact on the investor is reduced given the high number of other securities held in the portfolio. Investing in a bond fund also means that your money is more accessible, and you can choose to have your interest payments reinvested or distributed periodically.

A defensive asset with diversification benefits

Many investors use fixed income, particularly government-issued bonds, as a defensive investment because it can help preserve capital. It also usually experiences less volatility than shares, and can pay a steady income stream through its regular coupon payments. It is viewed as lower risk than other asset classes such as equities and listed property.

Bonds can offer diversification benefits because they often perform well when shares perform poorly, which means that bond investments help to lower total risk within a diversified portfolio.

The total return on bonds comprises income from coupon payments plus any growth or loss from price fluctuations. The price or value of a bond, with fixed coupon payments, increases as the yield to maturity declines and vice versa.

Australian equities vs Australian bond returns

1 year rolling return of the ASX200 against the Australian bond index (Bloomberg Ausbond Composite 0+ Yr Index)

An overview of the Schroders fixed income funds

Schroder Fixed Income Fund

- Bonds play a critical role in investors' portfolios – whether it's to generate income, preserve capital or to guard against the volatility of more growth-oriented investments like shares. The Schroder Fixed Income Fund has been designed around all of these investor needs, and provides an actively managed defensive strategy to investors. The Fund comprises a core of investments in high quality Australian fixed interest investments and is complemented by a diverse range of global investment opportunities to bring balance, risk control and return enhancement.

- This product is likely to be appropriate for an investor seeking capital preservation and income for a small or core component of their portfolio, with a medium risk and return profile. This product is unlikely to be suitable for an investor seeking capital growth or someone seeking high returns.

Schroder Absolute Return Income Fund

- In the current volatile interest rate environment, it is important for investors to achieve adequate returns on their investment, whilst also receiving reliable income and protecting their capital from the impact of potential interest rate changes. The Schroder Absolute Return Income Fund is an actively managed bond strategy that aims to meet all of those objectives for investors.

- The Schroder Absolute Return Income Fund is available as a managed fund and as an exchange traded fund (ETF). CBOE exchange code: PAYS.

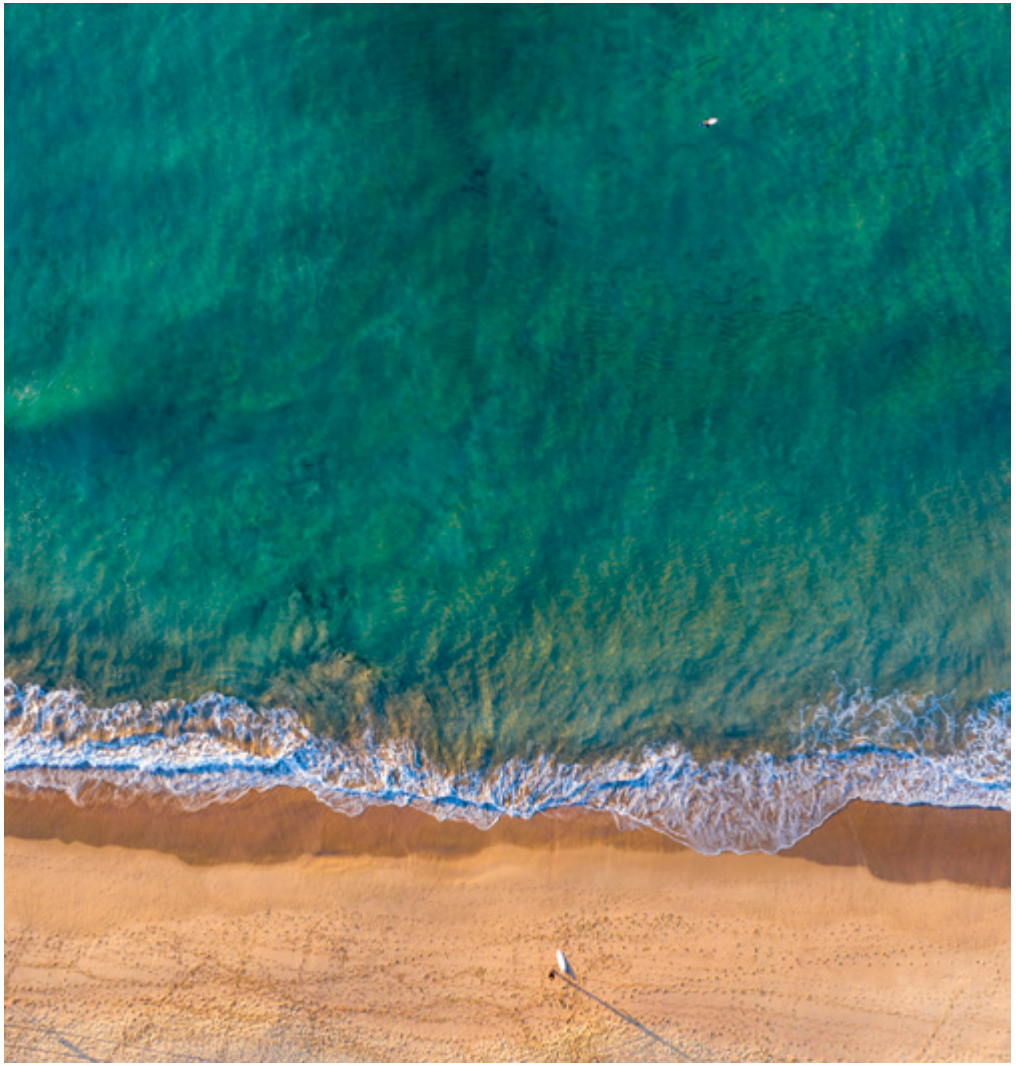
- This product is likely to be appropriate for an investor seeking capital preservation and income for a small or core component of their portfolio, with a medium risk and return profile. This product is unlikely to be suitable for an investor seeking capital growth or someone seeking high returns.

Schroder Absolute Return Income (Managed Fund) Exchange code: PAYS

- An actively managed fixed income exchange traded fund (ETF) that focuses on meeting investors' needs for reliable monthly income, while at the same time giving peace of mind that there is a strong focus on managing risk should markets fall.

- This product is likely to be appropriate for an investor seeking capital preservation and income for a small or core component of their portfolio, with a medium risk and return profile. This product is unlikely to be suitable for an investor seeking capital growth or someone seeking high returns.

For more information about our investment opportunities in bonds and fixed income, please visit the Schroders website at: schroders.com/en-au/au/individual/funds/bonds/



Glossary of Terms

Accrued interest

The amount of interest accumulated on a bond since the previous coupon payment date.

Asset allocation

An investment strategy that attempts to balance risk versus return by adjusting the percentage of each asset in an investment portfolio.

Bond

A debt security or loan, as a condition of which the issuer or borrower undertakes to make specified interest or income payments, at regular intervals and to repay the principal, or capital amount, at maturity.

Cash rate

The official interest rate used by the Reserve Bank of Australia (RBA) to influence interest rates.

Coupon rate

The rate of interest paid by the issuer of a bond. The rate is usually expressed as an annual percentage of the face value of the security.

Credit risk

An assessment of the likelihood that a company issuing a bond may default on its obligation to pay interest or repay principal.

Credit spread

A spread is the difference in yield between two securities with similar maturity. A credit spread generally measures the degree of risk between a 'risk free' asset and an asset with credit risk.

Current yield

The current yield (also referred to as the running yield) represents the annual coupon receipts as a percentage of the current market price.

Default

The default risk refers to the risk that the issuer will not be able to make the scheduled interest payments and/or repay the principal at maturity.

Defensive assets

Investments focused on achieving stable returns, including cash and debt securities.

Duration

A measure of the sensitivity of a bond's price, or market value, to a change in the market interest rate. Higher duration means higher sensitivity in the bond price to changes in interest rates.

Inflation risk

The risk that the return of an investment is eroded or below inflation, reducing the purchasing power of an investor's funds.

Interest rate

The cost of borrowing money, or the return on funds, provided by a lender.

Issuer

Borrower (government, financial institution or company) that issues the bond or security.

Liquidity

The ease with which an asset can be bought, or sold, in the market without significantly affecting the price. A liquid bond can be bought and sold more easily than an illiquid one.

Maturity

The end of a bond's life when capital must be repaid to the investor.

Nominal yield

The interest paid per annum over the face value of the bond.

Principal

The amount of funds borrowed, or face value of the security.

Spread

The difference between the buy price and the sell price of a bond. It represents the cost of a transaction to buy or sell a bond.

Volatility

Measures the variability of returns from an asset over a given period. Shares experience significantly higher volatility than government bonds. Cash investments have close to zero volatility.

Yield (yield to maturity)

The total expected returns on a debt security, expressed as an annualised rate of return.

Yield curve

Shows the yields available from bonds issued by the same borrower over different maturity dates, starting with the bond closest to maturity out to the longest maturity.

Schroders

Schroder Investment Management Australia Limited
Level 20, 123 Pitt Street, Sydney, NSW 2000
T +612 9210 9200

schroders.com.au

CAN-SCH070_008_08.23