MACTE · INVEST

# Bonds

## General information

Bonds are fixed income or debt instruments that are issued by various organizations with an aim to borrow money for a realisation of a project, restructurisation or other reasons. Organisations can use issuance of debt instruments as an alternative to asking for a loan to a bank.

Investor, who purchases the issued bonds become a creditor to the issuer. The issuer is obliged the repay back the borrowed money to the investor at the maturity of the debt instrument. In case the issuer is unable to repay back the borrowed funds, it faces default. Additionally, issuers often (but not always) pay interest to investors in return for use of their funds.

Generally bonds can be sold to other willing investors on the secondary market. When determining the price on the secondary market, numerous factors are taken into account, such as liquidity of the instrument, current interest rates, and issuers ability to repay the investment along with its credit rating (if any).

## Types

Bonds can be categorized in various groups based on different measures. Key measures are listed below:

- Issuer – bonds can be categorized based on the type of issuer. Bonds can be issued by companies (corporate bonds), cities and localities (municipal bonds) as well as countries (government bonds) and even international organizations, such as International Monetary Fund or World Bank (supranational bonds).
- Coupons – bonds can be categorized based on the type of interest it pays to the investors. Coupons can be fixed (predetermined at the moment of bond issuance), floating (depending based on predetermined criteria) or inexistent (there are no coupon payments). Coupons are paid on a regular basis (yearly, half-yearly, quarterly or monthly).
- Credit rating – bonds can be categorized based on the issuer's ability to repay the bond, which is often distinguished with credit ratings assigned by globally know credit rating agencies. Credit rating agencies assign ratings from AAA (S&P and Fitch) and Aaa (Moody's) for prime bonds to D and "/" respectively for bonds in default. All bonds with credit ratings below BBB- and Baa3 are considered junk bonds.
- Maturity – bonds can be categorized based on what is their time to maturity. Generally, bonds with maturity shorter than one year are considered short term, bonds with maturity with maturity in one to 10 years are considered medium term and bonds with maturity in over 10 years are considered long term bonds. A special type of bond is perpetual – bond with no set date of maturity.
- Seniority – bonds can be categorized based on their seniority in relation to other bonds of the same issuer. Seniority level indicate the order of debt repayment in case of issuer's default. Senior secured debt will have considerably higher rate of recovery than, junior subordinated bonds.
- Complexity – bonds can be categorized into simple or complex financial instruments. Bonds are considered complex if they hold special features, which make them more difficult to understand. Examples of complex bonds are those with embedded derivatives, as well as convertible bonds. Bonds with no special features are considered simple.

Bond's riskiness and its yield and price accordingly is closely related to all above measures and should be considered during evaluation of a new investment.

## Value

When investing in bonds, generally investors can expect a predictable income in the form of coupon payments and return of invested funds at a certain date in the future (the maturity date). While there can be numerous variations in terms of coupon payments, seniority and complexity of the bond, fixed income securities are considered less risky in terms of price fluctuation as well as investment repayment at the end of the investment period. Due to being relatively safer investment, bonds often provide smaller return in comparison to equities.

Bonds can be sold in the secondary market as an alternative to holding it until its maturity. In this case, client may not receive his or her investment in full amount. Market price of the security on the secondary market depends on various factors:

- supply and demand of the bond;
- the issuer's credit rating representing its ability to repay the loan to its investors and overall representation of the company;
- current interest rate – bonds and interest rates have an inverse relationship. When interest rates (cost of borrowing money) rises, bond prices generally fall, and vice-versa. The longer the maturity of the bond, the greater the impact of interest rate fluctuations on the bond price.

## Target market

- Type of clients: bonds may be traded by non-professional clients, professional clients and eligible counterparties;
- Client experience and knowledge: clients with general knowledge (understands the information provided by the Intermediary) about the bonds;
- Client's financial situation and possibility of incurring losses: Mainly investors with tolerance for zero or moderate loss. Investors may incur losses of up to 100% when investing in non-investment grade bonds.
- Client's risk tolerance: Low to Medium for investment grade bonds, high – for high-yield bonds.
- Client's objectives and needs:
  - Investment tenor: Short, medium and long term.
  - Investment objective: Capital protection and future income stream.
  - Liquidity: Mainly willing to hold investment until its maturity with an option to exit the investment early.

## Risks

Investing in bonds is associated with a number of risks. Below list of risks associated with investing in bonds may not be comprehensive and may vary depending on the characteristics and classification of the bond.

- **Interest rate risk** is the risk that due to inverse relationship between the interest rates and bond, rising interest rates will result in bond prices falling. This relationship reflects the potential for investors to obtain a higher rate of interest elsewhere. This relationship hold also in the other direction – falling interest rates will result in bond prices rising.
- **Credit risk** is the risk that the issuer's financial position will deteriorate when the issuer is no longer able to pay interest or pay its debts. This risk is assessed by credit ratings, but it should be noted that they only reflect the opinion of the agency and the situation may have changed. Nor is a rating an absolute guarantor of the quality of a financial instrument;

- **Default risk** arises when the issuer is unable to make the interest payments related to the issued bond or its principal payment at the redemption date. In the event of an issuer's default, investor can lose up to all its investment.
- **Market risk** is the risk related to general factors affecting the whole market of financial instruments, such as the economic situation of the country, instability of national exchange rates, changes in key interest rates, etc.;
- **Reinvestment risk** is the risk that in an environment of falling interest rates, investors will have to reinvest their received coupon income as well as the principal of the bond at its maturity at lower prevailing rates.
- **Liquidity risk** is the risk that the invested funds will not be able to be withdrawn at the desired time, for example, due to the fact that there are no people willing to buy bonds at that time, so the price of the financial instrument may need to be reduced.
- **Inflation risk** is the risk that during inflation the purchasing power of the bond's future coupon payments and principal at maturity is reduced. As bonds tend to offer fixed and relatively small returns, this type of financial instrument is particularly sensitive to inflation changes. Additionally, rising inflation may lead to higher interest rates, which is also a negative factor for bond prices.
- **Systemic risk** is the probability that the insolvency of one financial brokerage firm, credit institution or investor will adversely affect many financial brokerage firms, credit institutions or investors;
- **Regulatory risk** is the risk of incurring losses due to unexpected provisions of national legislation. Therefore, before investing, it is important to look at the legal regulation of the market in which you intend to invest, especially when investing in the market of a little-known country;
- **Issuer's risk** - the value of a financial instrument may decrease due to reasons caused by the issuer: these may include performance, financial indebtedness, reduced demand for the issuer's goods / services, the sector in which the issuer operates, etc.

## Taxes and Fees

Tax treatment varies according to individual circumstances and tax residencies of each client.

Fees applied:

- Brokerage and third party fees related to transactions with bonds;
- Safekeeping fee.

Fees applied are subject to changes over time. Current price list is available on Macte Invest FM AB website.