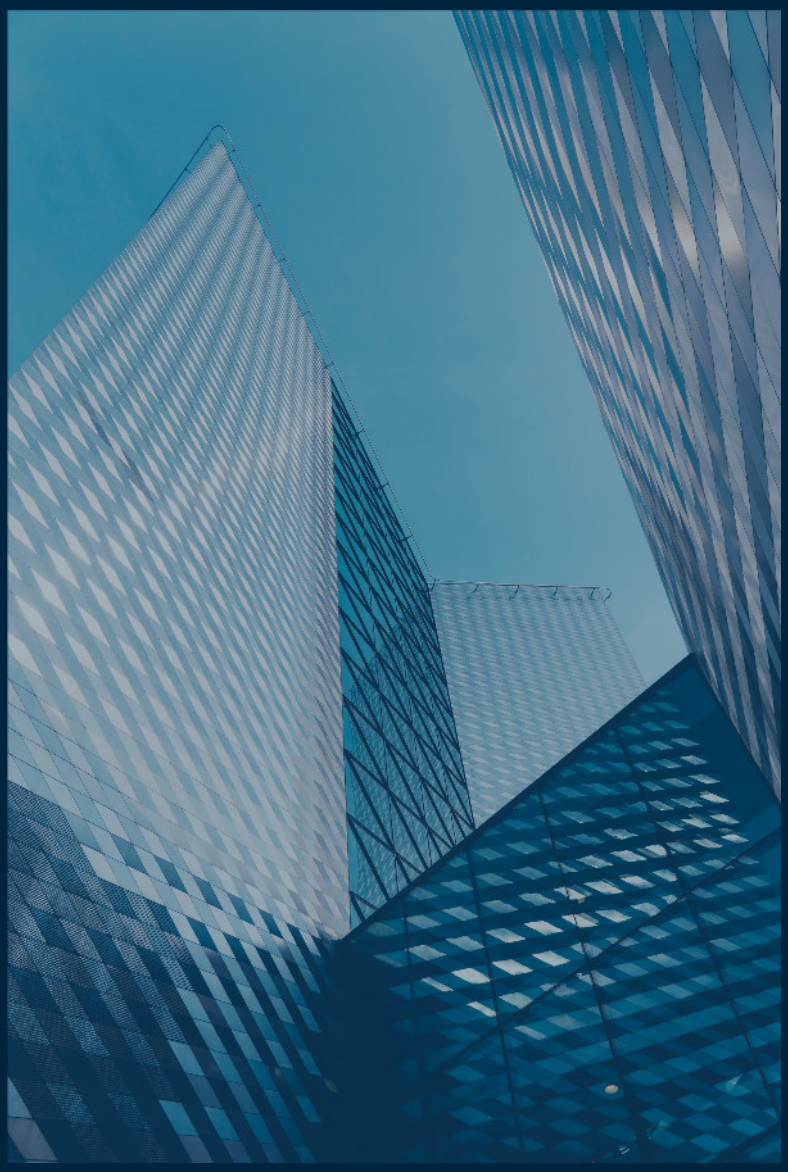
An Introduction to Bonds



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What is a Bond?

Companies both here and overseas raise money to fund the production of their products or services. We refer to that money raised as ***capital***, as it can basically take one of two forms within capital markets – it's either ***debt or equity***.

Equity Capital

When you own shares, you own part of the equity in that company.

Equity in a company ***represents ownership*** in that company. Most Australians are invested in equity through the stock market.

Local & International Companies

Debt Capital

Debt on the other hand is not ownership but takes the form of loans. When a company wants to use ***capital*** for a particular purpose, it ***borrows money from investors*** in the form of a loan. A ***"bond"*** is just another name for that loan.

Similar to the stock market which allows investors to own part of a company by breaking it into shares, the ***bond market*** allows investors to ***own portions of a loan*** by ***breaking down the large bond issue into tradeable parcels***. So, when you own a bond, you own part of the loan that has been made to the government or a corporation.

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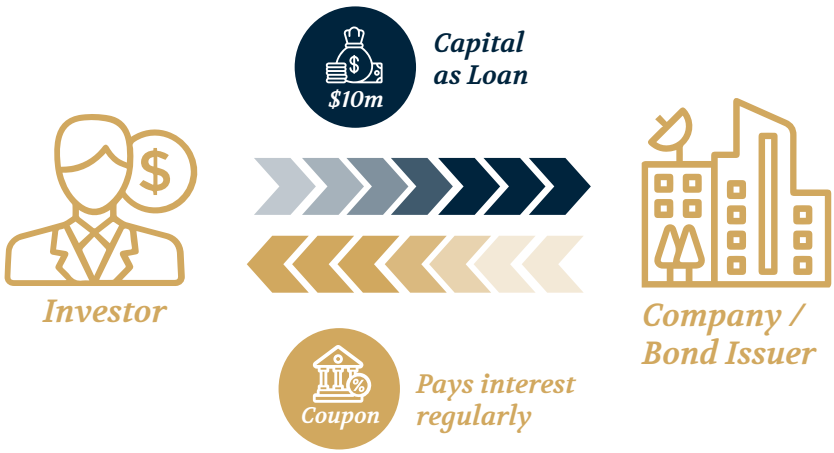
Now that we understand that when you own a bond you are essentially lending money, let's take a closer look at what characteristics make up that bond. The ***three most important*** characteristics of a bond are -

To explain these concepts, let's assume a company wants to raise $10m for 5 years to finance the building of a factory.

The company will look to ***issue $10m of bonds to be repaid after 5 years***. The ***maturity date*** of the bond will therefore be the date in 5 years time - when investors ***get their principal investment returned*** to them and the bond effectively expires. The ***interest rate*** that is paid to lenders is called the ***coupon rate*** and the company will typically pay the bond's coupon rate to the lender ***monthly, quarterly, or semi-annually.***



To indicate the ***credit quality*** of the borrower, the borrowing company might pay to have the bond ***rated by a rating agency*** – usually Standard & Poors, Moodys and/or Fitch.

The rating allows the lender to understand the credit quality of the borrower which, in turn, allows bond markets to ***assign an appropriate coupon (interest) rate to the bond***.

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Once everyone in the market understands the maturity date, the rating and the coupon rate, the bond is issued to the market.

The ***issue price is usually $100*** which is also referred to as ***"par"***. This is also the price that the bond will usually mature at. In other words, investors - who are the bondholders - can buy say, ***$100,000 of BBB rated bonds at par*** for a ***coupon rate of 5% for 5 years*** and they will receive ***$5000 income every year*** before receiving back their $100,000 in 5 years time.

Buying investment grade bonds rated BBB or higher generally means that bondholders are highly likely to receive all coupon payments and have their principal returned to them upon bond maturity.

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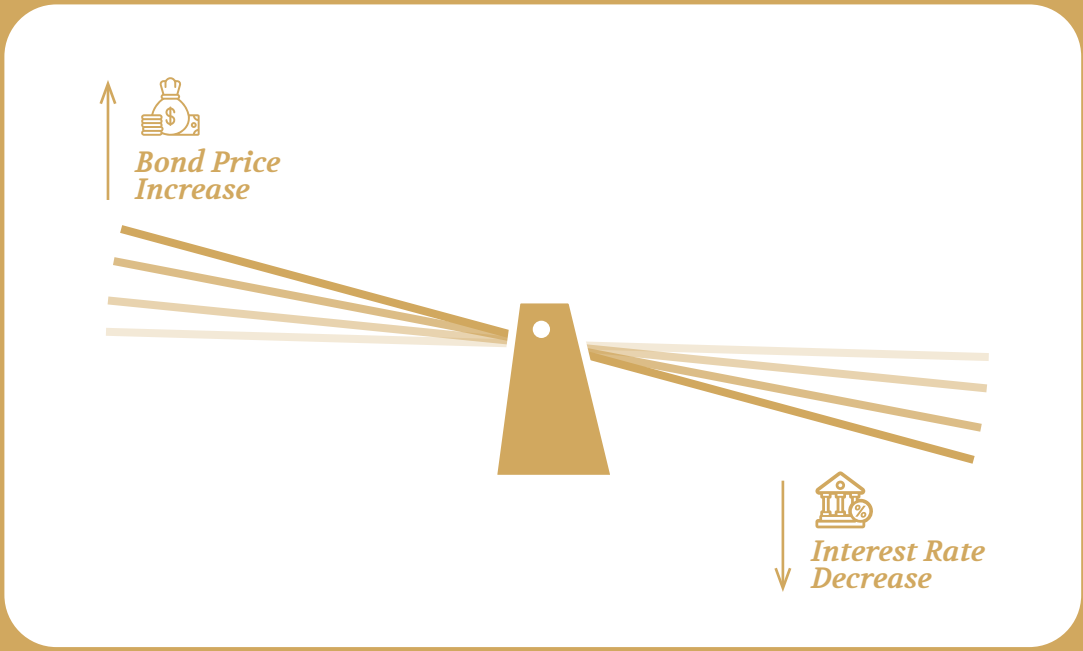
How do Bonds work?



Now that we know what a bond is, we can look at how it works. The major point to remember with bonds is that a ***bond's price will move inversely to changes in interest rates***. This is because if interest rates move down, the coupon on newly issued bonds will be lower than the coupon you are receiving on your current bond. This means that your bond is more valuable because your coupon is higher than new bonds issued at lower interest rates.

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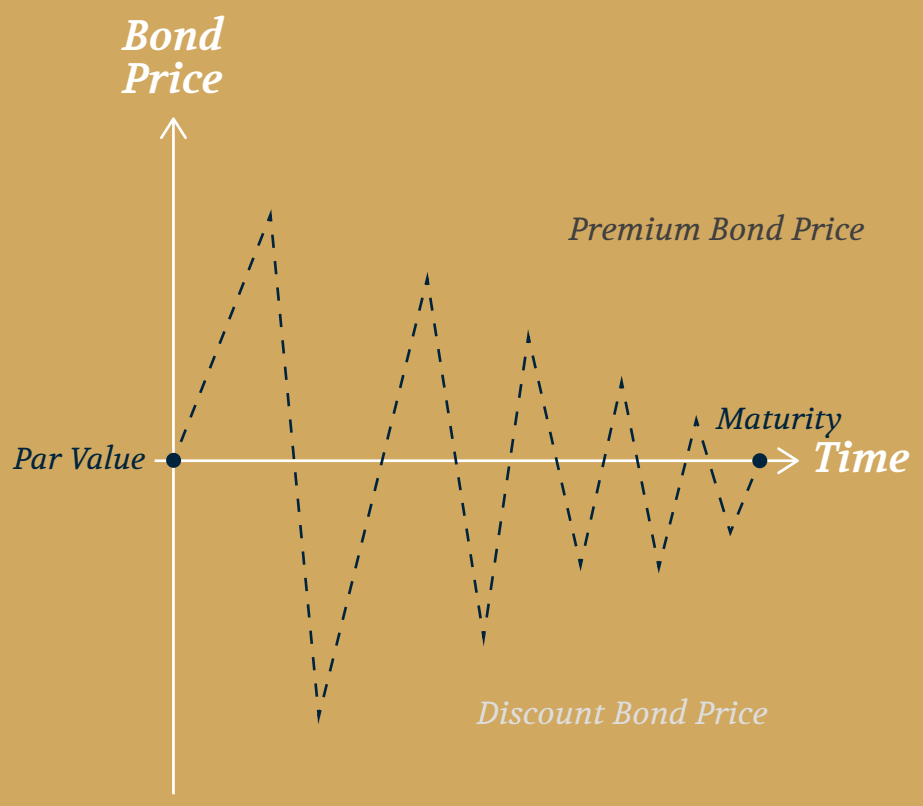
Critical to understanding how a bond works is the ***concept of 'duration'.*** A bond's duration is a function of its coupon and maturity date. The ***longer a bond's duration, the more sensitive the bond's price is to interest rate*** movements.



If interest rates rise, the price of the bond will fall, but for bonds with longer maturity dates and therefore longer duration, the price will fall more than for bonds with shorter duration. Conversely if rates fall, longer duration bonds will see substantially higher price increases. Regardless of the movement of prices however, every bond will mature at par assuming the borrower doesn't default. That means that the ***price volatility of the bond will decrease as maturity gets closer.***

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A bond portfolio manager will consider the following ***four major factors*** to ensure the price volatility matches the investor's risk/return profile.

Lower Duration

The lower the duration, the less price volatility for any change in market interest rates.

Higher Credit Ratings

The higher the credit rating, the higher the quality of the bond issue. Highly rated bonds will see less price volatility than lower rated bonds.

Floating Rate rather than fixed rate bonds

Floating rate bonds reset coupon levels based on short timeframes of 1 or 3 months, while fixed rate bonds have coupons that are generally fixed until maturity.

Issuer Liquidity

Bond issuers who come to the market all the time are well known to lenders and will experience less price volatility due to liquid markets.

As with all investments though - bonds exhibiting less price volatility will generally see lower coupons and therefore less income. ***Less risk equals less return.***

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What are the advantages of investing in Bonds?

Now that we understand what bonds are and how they work, we can explore how bonds can be advantageous to an investor's portfolio. In general, there are ***3 main advantages of holding bonds.***

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1 *Investors are guaranteed an income and they know exactly what it is.*

Companies are not obligated to pay share investors a dividend. Dividends can be cut or eliminated by a company at any time and there are no ramifications or penalties for dividend cuts or cancellations. Coupons on the other hand must be paid. ***If a coupon is not paid the company is in default***, and this is usually associated with companies in financial distress.

The legal obligation to pay the required coupon is maintained until the bond matures. This means that ***investors can match their asset return and maturity to their income timeframe and demands***. For example, An investor who requires $50,000 each year for the next 5 years can seek to purchase bonds paying $50,000 annually in coupons, thereby locking in that amount of income for the next 5 years.

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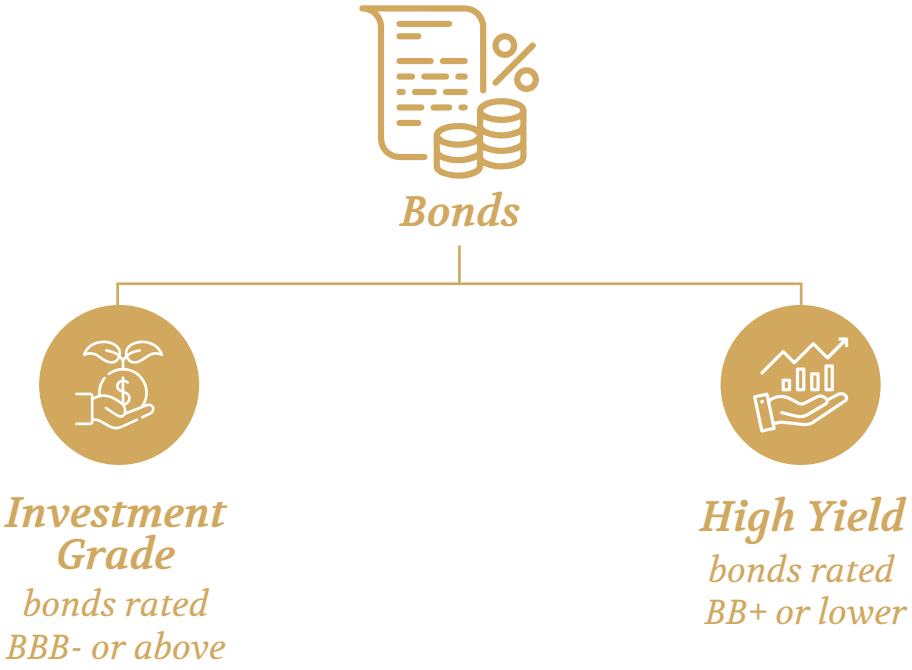
2 *Investors can choose their own risk profile.*

Shares are not rated but most liquid bonds are. Bonds are split into 2 groups – ***Investment Grade and High Yield***.



Investors can therefore choose a portfolio mix that best suits their individual risk/return profile. Investors wishing to have ***more return and are willing to risk greater price volatility*** may decide to have a significant portfolio allocation to ***high yield bonds***, while those investors wishing to see ***less price volatility*** may choose to purchase a greater proportion of ***investment grade bonds***.

The portfolio mix depends entirely on the investor's risk portfolio. With shares however, investors can see substantial price volatility with large companies as well as small.

Control over the price volatility of a share portfolio is much harder as a result. In additon, because bonds sit above equity on a company's balance sheet, ***it is not possible for bond investors to lose their principal due to default*** unless shareholders have lost all of their money first!

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3 *Unrealised price declines recover as the bond nears maturity.*

We've discussed that bonds with lower ratings, higher duration and less liquidity might see increased price volatility. Regardless of price volatility though, unless the company or government defaults on its debt, ***the unrealised price decreases or increases will revert to par for maturity.*** Unlike shares that have no maturity date and can permanently fall in price below where investors purchased the shares, ***bonds must mature at par***.

This is a very important point to keep in mind when investing in bonds and is one of the reasons direct bond purchases are superior to indirect bond purchases through bond funds.

These are the 3 major advantages for including bonds in your portfolio but there are other more general advantages for investing in bonds such as ***portfolio diversification and asset allocation efficiencies.***

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How will Bonds operate in my portfolio with Thesan?

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The Problem

Most investors invest in bonds through bond funds. ***A common problem when investing in bonds through bond funds is reduced transparency.*** When an investor invests in a bond fund, they are buying units in a trust that invests in bonds.

The fund manager may provide information on the ratings mix or the weighted average duration of the portfolio or the weighted return of the portfolio, but they generally don't show all the holdings of the trust. Even when they do, all unit holders must hold units in the same portfolio, even if some unit holders have different risk/return profiles from other unit holders. Although portfolio returns are reported, ***unit holders generally won't know whether the profit or loss of the fund is realised or unrealised.***

This is very important given that most unrealised losses in bonds will be recoverable as the bonds approach maturity. In short, holding units in trusts invested in bonds can take away many of the advantages of investing in bonds that we have previously discussed.

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The Solution

At Thesan we offer investors ***direct access to bonds*** through their own individual managed account. Investors don't own units in a trust – they own the bonds in their own name. The bonds are kept at a custodial bank in the name of the investor or their self-managed superannuation fund. Investors will be ***able to view*** which bonds they own, the amount invested, the rating, maturity profile, coupon rates, cashflows and the prevailing market price. Investors ***will know whether the profit/loss on the portfolio*** is realised or unrealised such that the price will tend to par through time. ***With transparency comes greater investor understanding*** and therefore a sense of security about the bonds owned and the income profile.

Unlike units in a bond fund, your bond holdings ***will not be negatively impacted by withdrawals*** made by other unitholders in the fund. You therefore have more control over your portfolio as only Thesan and you control the direction of your bond portfolio.

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Rather than the one-size-fits-all approach of a bond fund, your bond portfolio is ***customised to your individual risk/return profile***. You direct Thesan as to which risk profile you are comfortable with, and we ensure that your portfolio meets your risk/return expectations in terms of duration, coupon reset profile, rating, maturity and issuer concentration. ***It's your bond portfolio specifically designed for your needs.***

Thesan offers ***complimentary consultations*** for wholesale investors who wish to learn more about investing in bonds to generate consistent and reliable income. You can arrange consultation via our website at http://www.thesanfunds.com.

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