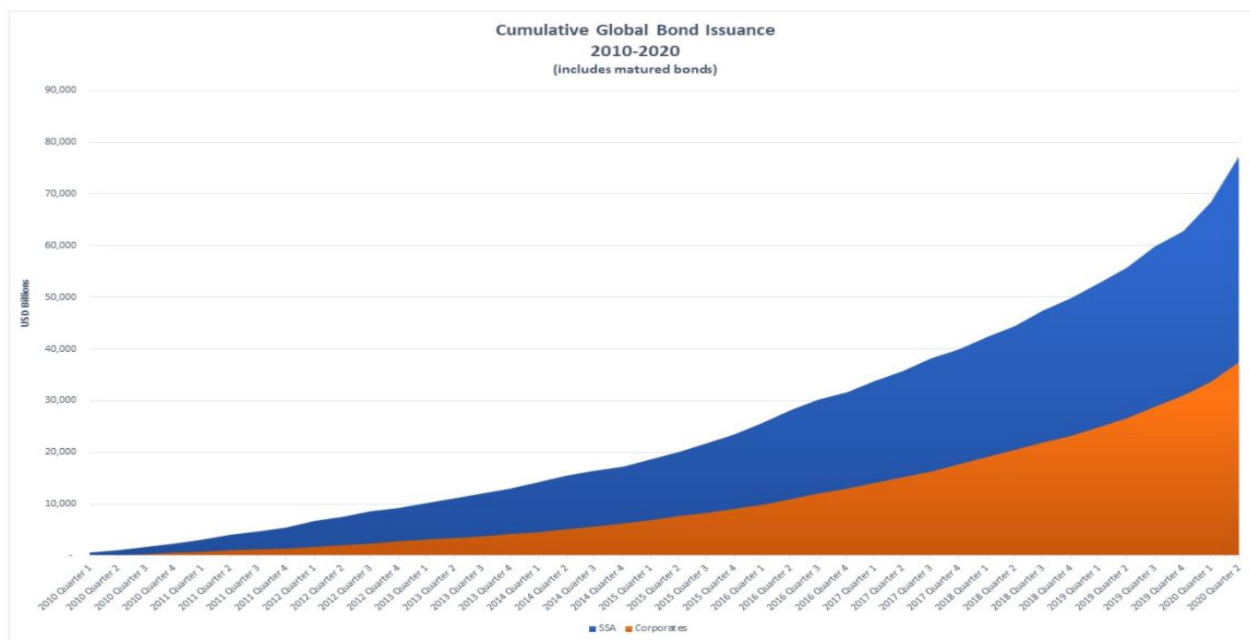
FINANCIAL PLANNING WALES

Nominal Bonds
&
Inflation Linked Bonds

Introduction

The International Capital Market Association (ICMA) estimated that as of August 2020, the size of the global bond market in USD terms was approximately $128.3tn[1].

The current levels of global debt are unprecedented, except during periods of war, with a huge amount of issuance since 2010, following the Quantitative Easing (QE) policies that followed the 2008 Financial Crisis and in response to the COVID-19 Pandemic.



Source: ICMA analysis using Bloomberg Data (August 2020)

But what exactly are Bonds and what role can they play as part of a Portfolio for individual investors.

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[1] ICMA Global Bond Market size August 2020.

Newport
The Estates Office
25-26 Gold Tops,
Newport, NP20 4PG

Cardiff
62 Cathedral Road,
Cardiff,
CF11 9LL

T: 02920 641188
E: adviser@financialplanningwales.co.uk
W: www.financialplanningwales.co.uk

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What are Bonds?

Put simply, a bond is an 'I owe you' that can be issued by a company or government in order to raise capital from investors. The issuer pays interest (known as a coupon) to the investors during the life of the bond and repays the original sum of money at the end of the agreed term. The bonds represent the debts of issuers that are sliced up and sold to investors in much smaller units.

The return that the investor can expect on a bond is referred to as the 'yield'. This allows the investor to assess the value of the bond in comparison to other investments such as equities or cash.

The **Current Yield** is a comparison of the income from the bond against its cost and is calculated by taking the annual coupon, dividing it by the bond price and then multiplying by 100 to obtain a percentage.

The **Gross Redemption Yield (GRY)** is used, in addition to the Current Yield, to calculate the capital gain or loss when holding the bond until maturity.

Bonds are issued with a face value or 'par value' of £100 or $1000 (depending on the issuer), however once in the open market the price can increase or decrease. The asking price can be above the par value i.e. a premium; or it can be below the par value i.e. a discount.

It is important to note, that when the price of the bond increases, the yield declines – and vice versa.

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Types of Bonds

Bond issuers are typically divided into:

- Governments, and
- Companies or Corporations

Government Bonds

Most governments issue their own bonds as they are an easy and cost-effective way to borrow money. For example, the UK issues Gilts and the US issues Treasury Bonds. Typically, these Bonds will offer a fixed a coupon paid at regular intervals during the lifetime of the Bond.

Corporate Bonds

As with Governments, Companies or Corporations can also issue bonds to meet day to day expenditure, fund expansion or finance investment. This is often a cheaper way of raising capital for the Company, rather than financing via Banks. Typically, these Bonds will offer a fixed a coupon paid at regular intervals during the lifetime of the Bond.

Inflation Linked Bonds

An Inflation or Index Linked Bond is a bond in which payment of a regular coupon and redemption value that is linked to a specific price index, such as the Consumer Price Index (CPI) or Retail Price Index (RPI) for the respective country. This offers the bond holder a known real return.

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When do bonds work well?

Ray Dalio, of Bridgewater Associates, has published an excellent piece of research which highlights the macro-environment in which various assets, including Nominal and Index Linked Bonds, perform well -

The table below illustrates our view of how different macro environments (i.e. rising growth, falling growth, rising inflation, and falling inflation) benefit different asset classes. By balancing risk equally across the four environments, we can consistently earn asset class risk premiums while minimizing the portfolio's susceptibility to any one environment.

	GROWTH	INFLATION
RISING	25% of Risk • Equities • Corporate Spreads • Commodities • EM Debt Spreads	25% of Risk • Inflation-Linked Bonds • Commodities • EM Debt Spreads
FALLING	25% of Risk • Nominal Bonds • Inflation-Linked Bonds	25% of Risk • Nominal Bonds • Equities

For example, in a falling growth environment Nominal and Inflation Linked bonds benefit. In an environment of rising inflation, Inflation Linked Bonds benefit. In an environment of falling inflation, nominal bonds benefit.

Nominal bonds have historically been used in Portfolios as a means of providing –

- A secure, predictable income via a regular coupon.
- Reduced volatility - In many instances Bonds with high ratings of creditworthiness are referred to as 'Safe Haven' assets, as they may be uncorrelated or negatively correlated to the general market.

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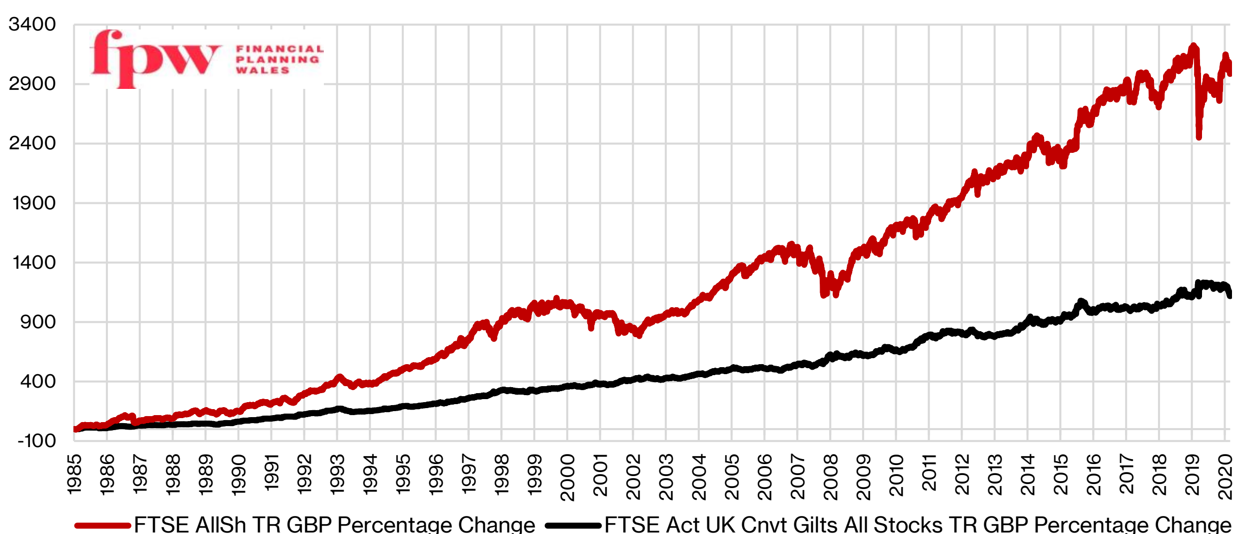
The late 1970s and early 1980s witnessed record high interest rates in the UK and US as a means of taming runaway inflation, which saw Bond yields reach significant highs. Following the successful pricking of the inflation bubble, Bond values increased, and yields fell as other forces worked to contain inflation, such as globalisaton. The trimming of inflation led to the much-publicised Bond Bull Market.

The strength of the bond bull market allowed Portfolio Managers to utilise what would become well known as the 60/40 strategy as a means of achieving a Balanced Portfolio. The 60% allocation to equities would enable the Portfolio to benefit from growth in equity markets; whilst the 40% allocation to bonds would reduce the volatility associated with equity investment and provide an income.

If we consider the returns of UK Nominal Gilts and the FTSE AllShare to 1985, we can see how equity markets have provided greater but volatile returns, whilst Gilts have demonstrated greater consistency –



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How we monitor them

When considering allocations to Bonds, we must first understand some of the risks –

- **Interest Rate Risk** – bond returns are highly dependent on changes in general interest rates. Increasing interest rates is typically negative for nominal bonds.
- **Inflation Risk** – as the annual coupon of a nominal bond is fixed, the investor is at the mercy of increasing inflation which can erode the purchasing power of the return.
- **Credit Risk** – the ability of the Bond issuer to repay the bond must also be considered. This is typically of greater concern in Corporate Bond markets. Bond issuances are often rated by rating agencies such Standard & Poors and Moody, who provide ratings for each bond depending on the creditworthiness of the issuer.
- **Duration Risk** – the sensitivity of the price of the bond to a change in interest rates.

To assess whether bond investment is appropriate, a framework can be created to review the trends of factors such as Interest Rates, Inflation, GDP and real GDP growth, and monetary and fiscal policy to name but a few. This can then be used alongside the assessment of the Macro-Environment as mentioned above.

In respect of Index-Linked Gilts and US Treasury Inflation Protected Securities (TIPS), these offer a further dynamic, and we can assess the prospects for either inflation linked bond by comparing the 'Yield Spread' between them to identify when one is likely to offer superior returns to the other.

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Conclusion

The role that Nominal Bonds and Inflation Linked Bonds play in Portfolios is important in providing protection against periods of extended market volatility. However, they should form but one weapon in an armoury designed to provide capital protection and mitigation of inflation risk.

Moving forwards, the threat to nominal bond values remains elevated as many Governments are seeking to stimulate inflation via fiscal and monetary policies. Should a sustained period of high inflation persist, then the real value of nominal bonds will be eroded and lead to investors seeking alternative assets alongside Inflation Linked Bonds, that may offer protection of their purchasing power.

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