Understanding bonds:
How they work and why your adviser might recommend them
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The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.
A financial adviser may recommend bonds or bond funds for a variety of reasons, such as to help offset volatile price movements in other investments, or perhaps to generate income.

This guide will help you understand what bonds are, how they work and why your financial adviser may recommend them as part of your investment plan.

**You will find a glossary of key bond terms at the end of this guide.**

4 What’s a bond?
6 Where do bonds come from?
8 Bonds as investments
12 The risks and potential rewards of bonds
14 What next?
15 Glossary of key terms
What’s a bond?

A bond is simply a promise to repay money, with interest, in the future. While equities represent ownership shares in a corporation, a bond is an ‘IOU’ that obligates the issuer of the bond to pay the investor a specified sum of money at regular intervals and to repay the face value of the bond at a given future date.

Bonds in context

You can think of bonds as a loan, with the investor making the loan. When you invest in a bond, you loan money to an ‘issuer’, such as a corporation or the government, which needs it to fund business growth or meet immediate spending needs. In return, you receive regular income payments in the form of interest, just like the interest on a loan, except you’re the bank and you receive interest rather than pay it. The interest paid is normally fixed when the bond is issued, which is why you’ll sometimes hear bonds called ‘fixed interest’ or ‘fixed income’.

Bonds are issued for a set period and when that period expires – in other words, when the bond reaches its ‘maturity’ – the issuer promises to repay the face value of the bond.

Once issued, bonds can be traded and their prices fluctuate. However, when a bond reaches its maturity, the holder of the bond will receive the face value of the bond.
**Bonds: The basics**

- Issues bonds to the market place
- Pays interest to the bond holders (investors)
- Promises to repay principal when the bond matures

**Investors**
- Lends money to issuer by buying bonds
- Receives interest payments in return

**Bond issuers**

Always remember that the value of investments, and the income from them, may fall or rise and investors may get back less than they invested.
Where do bonds come from?

A variety of institutions issue bonds, including governments, international agencies and companies.

**Governments**

Governments around the globe issue bonds (also called ‘gilts’ in the UK or ‘treasuries’ in the US) to fund government spending or to cover budget deficits.

**Companies**

Companies also issue bonds (called corporate bonds). These provide credit to help finance a variety of operations, as an alternative to a bank.

Corporate bonds tend to be safer when issued by reputable companies and riskier when issued by weak companies. As a result, financially stronger companies can issue bonds that pay less interest than those offered by financially weaker companies.

**Understanding bond quality**

Bonds from stable governments, such as UK government bonds, are generally assumed to have a very low risk as they are backed by the UK government. As a result, investors accept that UK government bonds will pay a relatively low rate of interest.

A start-up biotechnology firm, on the other hand, might have to pay a higher rate of interest in order to persuade investors to take on the higher risk involved. Bonds like these are therefore called ‘high yield bonds’ and are sometimes called ‘junk bonds’.

A large stable company making solid long-term profits might also pay a low rate of interest because it is perceived as being relatively safe. These are often referred to as ‘investment grade bonds’.
The role of rating agencies

Credit rating agencies, such as Standard & Poor’s or Moody’s, rate bond issuers according to their credit worthiness, in the same way that individuals are given a credit score by banks. These ratings can be a useful starting point for understanding the credit worthiness of a bond.

A bond’s credit rating reflects the rating agency’s opinion of the issuer’s ability to pay interest on the bond and, ultimately, to repay the principal at maturity. If payments aren’t made in full and on time, the issuer has ‘defaulted’ on the bond.

### Bond rating codes explained

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Moody’s</th>
<th>S&amp;P</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment-grade bonds</td>
<td>Aaa</td>
<td>AAA</td>
<td>Highest quality with lowest risk; issuers are exceptionally stable and dependable.</td>
</tr>
<tr>
<td></td>
<td>Aa</td>
<td>AA</td>
<td>High quality, slightly higher degree of long-term risk.</td>
</tr>
<tr>
<td></td>
<td>A</td>
<td>A</td>
<td>High-medium quality, many strong attributes but somewhat vulnerable to changing economic conditions.</td>
</tr>
<tr>
<td>Baa</td>
<td>BBB</td>
<td></td>
<td>Medium quality, adequate but less reliable over the long term.</td>
</tr>
<tr>
<td>Non-investment-grade bonds</td>
<td>Ba</td>
<td>BB</td>
<td>Somewhat speculative, moderate security but not well safeguarded.</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>B</td>
<td>Low quality, future default risk.</td>
</tr>
<tr>
<td>Caa</td>
<td>CCC</td>
<td></td>
<td>Poor quality, clear danger of default.</td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
<td></td>
<td>Highly speculative, often in default.</td>
</tr>
<tr>
<td>C</td>
<td>C</td>
<td></td>
<td>Lowest rating.</td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td>In default, not paying interest or principal</td>
</tr>
</tbody>
</table>
Bonds as investments

Your adviser may recommend bonds, or pooled bond funds, to you for a number of reasons, such as offsetting the volatility of equities, or providing income in the form of bond interest payments.

Balancing your investment portfolio

Your adviser may suggest including bonds, probably in the form of regulated bond funds, in your portfolio to help offset some of the volatility of equities, since bond and equity prices rarely move together. But even when they do, movements in bond prices tend to be less extreme than the stock market. And the regular payments that bonds generate can be reassuring when equity prices fall.

The role of bonds

Your adviser will work with you to help you define your goals, time horizon and risk profile. They will then formulate an investment plan and construct a portfolio to help you achieve your goals. Within that portfolio, bonds can serve as an anchor, offsetting the volatility of equities.

As you can see from the table, equities have delivered greater returns over the last twenty years, but have experienced more periods of significant loss. Your financial adviser can help you determine the mix of equity and bond funds that is right for you.
The performance of difference investments from 1994–2014

The performance of an index is not an exact representation of any particular investment. As you cannot invest directly into an index, the performance shown in this table does not include the costs of investing in the relevant index. Basis of performance NAV to NAV with gross income reinvested. Indices used: Equities (MSCI AC WORLD, in GBP, Source: Thomson Reuters Datastream), Bonds (Barcap Gl. Agg, hedged in GBP, Source: Barclays)

**Past performance is not a reliable indicator of future results**
<table>
<thead>
<tr>
<th>Year</th>
<th>Bonds %</th>
<th>Equities %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>-2.41</td>
<td>-0.68</td>
</tr>
<tr>
<td>1995</td>
<td>19.26</td>
<td>20.38</td>
</tr>
<tr>
<td>1996</td>
<td>8.59</td>
<td>2.70</td>
</tr>
<tr>
<td>1997</td>
<td>11.82</td>
<td>19.60</td>
</tr>
<tr>
<td>1998</td>
<td>12.57</td>
<td>20.62</td>
</tr>
<tr>
<td>1999</td>
<td>1.05</td>
<td>30.92</td>
</tr>
<tr>
<td>2000</td>
<td>9.93</td>
<td>-7.14</td>
</tr>
<tr>
<td>2001</td>
<td>8.34</td>
<td>-13.69</td>
</tr>
<tr>
<td>2002</td>
<td>10.71</td>
<td>-26.75</td>
</tr>
<tr>
<td>2003</td>
<td>5.53</td>
<td>21.08</td>
</tr>
<tr>
<td>2004</td>
<td>8.04</td>
<td>7.93</td>
</tr>
<tr>
<td>2005</td>
<td>5.77</td>
<td>24.55</td>
</tr>
<tr>
<td>2006</td>
<td>3.30</td>
<td>6.60</td>
</tr>
<tr>
<td>2007</td>
<td>5.76</td>
<td>10.30</td>
</tr>
<tr>
<td>2008</td>
<td>7.59</td>
<td>-19.48</td>
</tr>
<tr>
<td>2009</td>
<td>5.30</td>
<td>20.56</td>
</tr>
<tr>
<td>2010</td>
<td>4.82</td>
<td>16.77</td>
</tr>
<tr>
<td>2011</td>
<td>5.80</td>
<td>-6.17</td>
</tr>
<tr>
<td>2012</td>
<td>5.93</td>
<td>11.67</td>
</tr>
<tr>
<td>2013</td>
<td>0.04</td>
<td>21.15</td>
</tr>
<tr>
<td>2014</td>
<td>7.92</td>
<td>11.22</td>
</tr>
</tbody>
</table>

**Past performance is not a reliable indicator of future results.**

The performance of an index is not an exact representation of any particular investment. As you cannot invest directly into an index, the performance shown in this table does not include the costs of investing in the relevant index. Basis of performance NAV to NAV with gross income reinvested. Indices used: Equities (MSCI AC WORLD, in GBP, Source: Thomson Reuters Datastream), Bonds (Barcap GL Agg, hedged in GBP, Source: Barclays)
Bond returns: the role of income

One of the benefits of a bond is that it can provide regular income. What you get back from a bond includes both the income it pays as well as any change in the bond’s price. Therefore your adviser may recommend bonds if you require an income from your investments.

Bond funds

A bond investment fund pools money from many investors to purchase a diversified selection of bonds. Bond funds come in several ‘flavours’, investing in the different types of bonds described previously in different mixes and levels of credit quality. Your financial adviser can help you to understand more about how these work.

Active and passive

Some bond funds are actively managed, which means professional fund managers try to pick a mix of bonds that will deliver returns that are better than a given benchmark. Others are ‘passive’ or ‘index’ funds which seek to track the performance of particular bond market benchmarks. Your financial adviser can help you decide which bond funds, if any, may be appropriate for your investment plan.
The risks of bond investing

Bonds are generally considered less risky than equities because their prices tend to be less volatile. But as with any investment, there is always some risk involved that you should discuss with your financial adviser.

**Interest rate risk**

A bond’s price generally decreases when interest rates rise and increases when interest rates fall. The longer a bond’s maturity, the higher the risk of significant fluctuations in its price caused by changes in market interest rates.

**Credit risk**

Bonds can lose value if the issuer fails to make interest or principal payments in a timely manner or if investors become less confident about the issuer’s ability to make such payments. Since a bond fund invests in many bonds, the impact of a downgrade of, or default by, any one issuer should be significantly reduced.
**Income risk**
Income from bond funds may fall because of declining interest rates. If you need income to pay for living expenses, you should expect it to fluctuate because of changes in bond yields. Income risk is higher for short-term bond funds and lower for long-term bond funds.

**Redemption risk**
Some bonds can be called, or redeemed, by the issuer before they mature – whenever the issuer wishes. When a bond is called, investors must reinvest their money, often at a higher price.

**Inflation risk**
The risk that the income paid by a bond will decline in real terms because of rising prices. The inflation risk is highest for short-term bonds, medium for intermediate-term bonds and relatively low for long-term bonds.

**Currency risk (for international bonds)**
Fluctuations in the value of the pound and foreign currencies can seriously affect the returns from overseas investments. A weaker pound can increase the value of foreign holdings, which would benefit a British investor. However, if the value of the pound rises the value of those foreign assets will fall.
What next?

This guide attempts to provide you with a basic introduction to bonds and bond investing.

With this knowledge, you can work with your financial adviser to decide if bonds or bond funds are appropriate for your investment portfolio, and if so, in what proportions.
Glossary of key terms

When discussing bond investing with your financial adviser, you might come across some of these terms:

**Benchmark:** A measure against which a portfolio’s performance is compared. A market index measuring the performance of a particular sector or style of a securities market is an example of a benchmark.

**Coupon:** The amount the bondholder receives in annual interest payments, shown as a percentage of the par value. Fixed rate bonds have a rate of interest set when the bond is first issued. Index linked or floating rate bonds pay an interest rate linked to an underlying figure, such as London Interbank Offered Rate (LIBOR) or inflation rates (Retail Price Index (RPI) in the UK at time of writing). The coupon is expressed as an annual rate but may be paid at more frequent intervals, most usually six-monthly.

**Credit quality or credit rating:** Used to rate a bond’s perceived credit worthiness or risk of default. For government bonds, it is generally based on a government’s taxation resources. For a corporate entity, the rating is derived from the company’s total debt picture, its profits and rate of growth, how it compares to similar entities and to the government, and the state of the economy. A bond’s credit rating is assigned by independent rating agencies, such as Standard & Poor’s and Moody’s. For Moody’s, investment grade ratings range from Aaa to Baa3, and for Standard & Poor’s, from AAA to BBB. Ratings from BB+ (Ba1 Moody’s) to CCC (Caa2 Moody’s) are considered non-investment grade (high yield, or ‘junk’).
**Current yield:** The bond interest expressed as a percentage of the bond’s current price. This percentage will fluctuate throughout a bond’s lifetime. The current yield is calculated by dividing the interest (coupon) by its price (coupon/price = current yield).

**Duration:** A measure used to gauge a bond’s interest rate sensitivity. Expressed in years, it indicates how much the bond’s price will react to each percentage point change in interest rates. For example, when interest rates fall by 1%, the price of a bond whose average duration is 4 years will rise by 4%. Conversely, if interest rates rise by 1%, the same bond’s market price will fall by 4%. The greater the duration, the greater the bond’s sensitivity to interest rate changes.

**Equities:** Ordinary company shares. A stock or other security representing an ownership interest in a company.

**Interest:** The amount paid to the holder of a bond by its issuer, expressed as a percentage of face value of the bond. They are typically listed on an annual basis. Interest represents a payment from the borrower to the lender for the use of the capital. See also: Coupon.

**Issuer:** The corporation, government or agency borrowing money by issuing the bond.

**Maturity:** The date when the final payment of principal and interest is due back to the bond holder, which is set when the bond is issued. Most bonds set maturity dates between one year and 30 years from the issue date.

**Par value:** The face value of a bond when issued. This is also the amount repaid by the issuer at maturity. When a bond trades above its par value, it’s being sold at a premium. When it’s sold below its par value, it’s being sold at a discount. While par value is fixed, the bond’s price will fluctuate throughout the bond’s lifetime in response to a number of variables.
**Term:** The life span of a bond, which begins at the bond’s issue date and ends on its maturity date.
- Short-term: 1 to 7 years.
- Intermediate-term: 7 to 15 years.
- Long-term: 15 to 30 or more years.

Generally, the longer a bond’s term, the higher the interest rate offered. Longer-term bonds are also usually more sensitive to interest rate changes.

**Volatility:** The amount that an investment’s value fluctuates over time. Volatility is often used to assess the potential risk associated with an investment.

**Yield:** Interest that a bond produces, usually given as a percentage of the current bond price. So, for example, if a bond price drops, the annual interest payment will be a higher percentage of that bond price so the ‘yield’ goes up.

**Yield-to-maturity (YTM):** The rate of return on a bond if the bond is held until its maturity date. The YTM is different from the coupon, as it expresses the total return on a bond rather than just its interest component. A bond’s YTM will be higher than the coupon rate if the bond is currently priced at a discount because of the extra return received when the bond receives its full par value at **Maturity.** The reverse is true when a bond is priced at a premium.
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