Investing in Fixed Income

STANLIB

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Investing in Fixed Income

Fixed income assets typically offer investors a regular income stream from their investment with an element of capital protection and some capital growth. They are considered a less risky alternative to owning shares and offer investors the opportunity to earn relatively stable returns, collect a regular and certain income while aiming to beat inflation. The fixed income market is now well-established in South Africa and with increasing complexity comes a wide choice of instruments within this asset class.

STANLIB is one of the largest fixed income asset managers in South Africa with one of the strongest and broadest capabilities in the country. In this note we explore the benefits and the risks of investing in fixed income as an asset class and provide insight on how these assets behave in various market cycles.

*Considered a less risky alternative to owning shares, **investors are attracted by the opportunity to earn relatively stable returns**, collect a regular and certain income while aiming to beat inflation.*

Understanding Debt Instruments

Investing in a fixed income fund means investing in a range of debt instruments at an agreed rate and over a set time period.

By investing in these instruments the investor is effectively providing a loan or debt to an organisation in return for interest payments at an agreed rate and time period. Capital is paid back to the investor on a specified date, known as the maturity date. The organisation issuing a debt instrument may be government, a bank or company raising money to finance business activities and growth. The debt instruments these organisations issue will range from short term money market type to longer term bonds.

The table below provides an outline of various money market type instruments and bond instruments and the factors which differentiate each type of instrument.

MONEY MARKET

Term or maturity:
Typically less than 12 months, may be as short as overnight

Example of instrument types:
Bank deposits
Negotiable certificates of deposit (NCD's)

Counterparties:
Banks

Other factors:
Highly liquid
Listed or unlisted

GOVERNMENT BONDS

Term or maturity:
Varies from short term of 1 year, medium term of 3 - 7 years and longer term of as long as 25 years

Example of instrument types:
Vanilla bonds
CPI bonds
Zero coupon bonds

Counterparties:
Government institutions
Municipalities

Other factors:
Listed or unlisted

SEMI-GOVERNMENT (SOE) BONDS

Term or maturity:
Short term: 1 – 3 years
Long term: 3 –10 years

Example of instrument types:
Mostly traditional fixed coupon bonds

Counterparties:
SOEs such as Eskom, Transnet, Land Bank

Other factors:
May have government guarantees
Listed or unlisted

CORPORATE BONDS

Term or maturity:
Mostly long term: 3 –10 years

Example of instrument types:
Traditional fixed coupon
Floating rate notes
Inflation linked bonds
High yield bonds
Convertible bonds
Zero coupon bonds

Counterparties:
Medium to large corporates including banks

Other factors:
Mostly illiquid other than bonds issues by major banks

The nature of each instrument outlined in the table above, gives rise to their specific risks and return opportunities.

Typically, the longer term instruments will offer a higher interest rate (return) in exchange for holding money longer, which means they come with a higher degree of risk.

Credit risk, which is the risk that the counterparty may not be able to make interest payments (default on payments) or return capital at a later date, is higher the longer the investment term.

Government bonds are typically less risky and pay lower interest rates. SOEs usually raise money to fund development and infrastructure and therefore provide the investor with an opportunity to invest in the economy's growth.

Debt instruments may be listed on an exchange (JSE) making them easier to trade. The term of the instrument generally determines its liquidity while demand for the instrument will influence the price.

Key factors impacting value

A number of factors influence the value of a debt instrument, including political stability and business confidence.

It is well-known that when **interest rates** go up, bond prices go down and vice versa. If a debt or bond holder receives payments based on a 10% interest rate and the market interest rate moves up to 12% then new investors would prefer to invest in a new bond paying interest at 12% resulting in a fall in value for the current bond.

The ability of the organisation to honour interest payments on the debt it has issued can have a significant impact on price, particularly for longer term instruments and in uncertain market environments.
An investor should do a thorough assessment of the organisation's ability to make payments – it's **creditworthiness**. Rating agencies will issue a credit rating on government and larger corporate debt to guide investors.

An instrument may be **attractive** due to economic or other factors driving investor **demand**. This would also influence the ease of trading or liquidity of the instrument.

Why invest in Fixed Income?

Investing in fixed income offers a number of potential benefits.

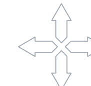
EARNING A STEADY AND RELIABLE INCOME

Fixed income investments offer the investor a steady and reliable source of income which is especially beneficial to those investors close to retirement or those already in retirement. Interest payments or coupon payments are made at regular intervals and give the asset class its name "fixed income". Company shares or stocks provide an income in the form of dividends. Dividend payments are made at the discretion of company management, which could decide to reinvest that profit into the company instead of paying it to shareholders. Coupon payments on bonds are different, since they are a legal obligation.

PROTECTING CAPITAL

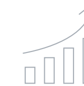
Fixed income assets are typically regarded as lower risk than equities given the legal obligations of the issuer to make regular coupon payments and to repay capital when the instrument matures. While this contractual obligation provides higher assurance of capital protection, an investor needs to consider the creditworthiness of the issuer, in other words how likely the issuer is to default on the debt or interest payments. An instrument's or issuer's credit rating provides a good indication of the issuer's ability to meet all these obligations and is typically assigned by a credit rating agency.

DIVERSIFYING YOUR PORTFOLIO



Bonds behave differently from other asset classes such as equities over various market or economic cycles. Allocating some funds to bonds enables investors to build a more resilient portfolio over time.

ENHANCING YOUR RETURNS



Some fixed income assets offer investors the potential to generate attractive returns, especially relative to similar assets in different regions and where factors such as liquidity may differ, for example unlisted credit instruments. Typically an investor would need to assume a higher level of risk. Portfolio managers, through skill and experience in identifying tactical investment opportunities, are also able to optimise returns in a fixed income portfolio.

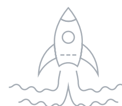
What are the Risks?

Investing in fixed income is not without risk.
These instruments generally provide a more attractive return than a bank fixed deposit and are typically less risky for an investor than owning shares or equities. However, the investor does assume some level of risk which is specific to the nature of the investment. Investing in fixed income gives rise to the following risks.

INTEREST RATE RISK

Interest rate movesments are one of the main causes of price volatility in bond markets. Bond investments typically lose value when interest rates rise. Longer term bonds are more sensitive to interest rate changes than shorter dated bonds. Fixed income portfolio managers consider the duration of a portfolio to measure its sensitivity to interest rate risk.

INFLATION RISK



Bonds provide investors with a fixed payment at regular intervals based on a specified interest rate. When the inflation rate increases at a faster rate than interest payments, an investor's purchasing power will be eroded. It is therefore important for a fixed income portfolio manager to consider the direction of inflation, to ensure that the portfolio continues to deliver real returns.

CREDIT RISK

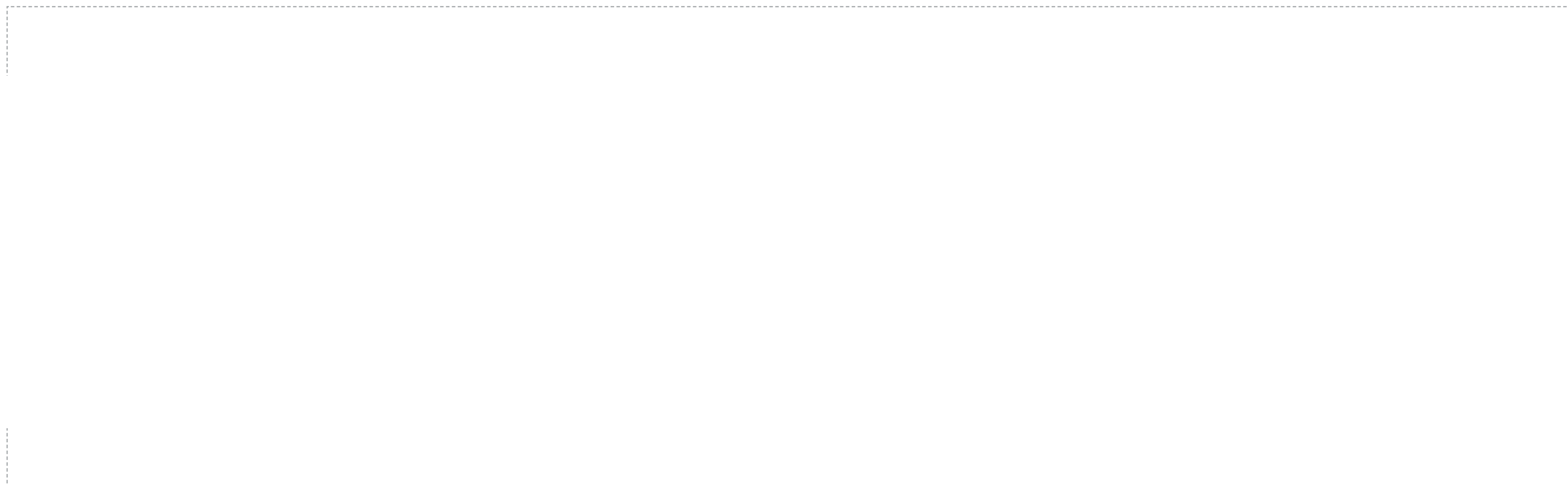
Credit risk is also known as default risk. If you invest in corporate bonds, you take on credit risk which is the possibility that an issuer could default on its debt obligation. If this happens, investors may not receive the full value of their principal investment or coupon payments.

LIQUIDITY RISK

Liquidity risk is the chance that an investor might want to sell a fixed income asset, but cannot find a buyer at a fair price. This is less of a risk with the widely-traded listed government bonds and more of a consideration for corporate bonds.

Terms worth knowing

***HOVER OVER** the name of **instrument type / grey block below** to see more information*



Portfolio managers consider credit spreads, expectations of interest rates and inflation as well as the shape of the yield curve to inform portfolio construction decisions.

During a market crisis, pricing of bonds may be highly influenced by the demand for these assets and as investors flock to the safety of cash, a sell-off will significantly impact bond prices regardless of credit quality or interest rate levels. Credit spreads, in this event, may widen significantly, depending on the perceived additional credit risk of investing in corporates over government bonds and the movement of interest rates.

Investing with STANLIB

The strength of STANLIB's fixed income capability means we are able to offer a wide range of portfolios to meet the investment needs of our clients. Our funds range from money market, which is a highly liquid, low volatility solution, to pure bond or inflation-linked bond. Our expertise across the spectrum of fixed income allows us to offer the STANLIB Flexible Income fund which invests in broad selection of fixed income assets, both local and global, as well as local property.

*STANLIB's Fixed Income team is **highly skilled and experienced at constructing portfolios** to optimise the return outcome promised to our clients and in **managing the ongoing opportunities and risks** associated with investing in a combination of fixed income instruments.*

Our investment decisions are backed by sound research, market experience and our ability to execute quickly when markets move. We have a compelling investment philosophy and process which has delivered great results for our clients over many years and in different market environments. Our portfolio managers seek to add value through the implementation of a multi-dimensional approach to active management using interest rate cycles, yield curve shape changes, duration management, credit positioning and relative value analysis.

***HOVER OVER** the name of **fund / grey block below** to see more information*

RISK, TIME HORIZON AND RETURN

The quick take

Over the last few decades the market has developed significantly, adding complexity to instrument structures and widening the investor's choice of debt instruments or fixed income assets. The benefits to investors remain the reliability of income through interest payments, capital preservation and the ability to diversify their portfolio of investments.

The level of risk will vary depending on the instrument, and could include credit risk, interest rate risk, liquidity risk and inflation risk. During uncertain market environments these risks can be significantly amplified but that also creates opportunity.

Fixed income solutions range from money market type instruments which offer a reliable income at a higher return than a fixed deposit to higher risk corporate bonds which can be long term in nature, with various structures which offer enhanced return opportunities for the risk taken.

Portfolio management requires skill and expertise to both construct and manage a portfolio of fixed income assets in changing market environments. STANLIB's depth and breadth of experience means we are able to offer a wide range of fixed income funds to meet varying client needs.

The benefits to investors remain the ***reliability of income through interest payments****, the* ***preservation of capital*** *and the ability to diversify their portfolio of investments.*

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