NICO Asset Managers

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INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy
22 March 2019

Topic 305: Investing in bonds

Last week, we introduced a topic on Investing in bonds. We looked into the characteristics and the benefits of investing in bonds. This week, we will look at the risks investors face when investing in bonds.

Every potential investor is faced by both benefits and risks to any investment. Some of the imminent risks from investing in bonds include default risk, inflation risk, market risk, call risk, liquidity risk and interest rate risk.

Risks of investing in bonds.

Default risk or Credit risk

Default risk also known as credit risk is the possibility that the bond borrower will not be able to make payments to the bond holder on time or at all. This is all dependent on the financial status of the bond issuer and the type of bond one holds.

Inflation risk

This is the probability of loss resulting from erosion of the value of income from an asset as a result of increase in inflation. The bond interest payments are for a fixed term and therefore, their value is affected by inflation changes. Long-term bonds are highly exposed to inflation risk than short term bonds. For example, if the bond's interest rate is lower than the prevailing Inflation rate, the bond holder loses out as they earn negative returns from holding the bond.

Market risk

This risk comes from the possibility that the bond market will be flooded with more bonds than demanded for. This decreases the prices of the bonds as the supply is greater than the demand for them. Therefore, if you are holding a bond; the price of your bond investment will also decrease irrespective of the quality. If you are thinking of selling it, you will sell it at a lower price than which you initially bought for.

Call risk

Call risk emanates from the possibility that the bond borrower will re-call the bond from the holder before maturity date. Some bonds have stipulations that give the bond borrower the right to re-call the bond before maturity date. On a specific date before maturity, the borrower has the right, but not the obligation, to buy back the bonds from the bondholders at a defined call price. This typically happens when the prevailing market rates are low and the bond borrower see this as an advantage to offer new bonds at lower interest rates.

Liquidity risk

The bonds are not as liquid as shares are. Bond investors tend to hold on to them rather than sell them off until maturity. As a result of this, the market for bonds will tend to be illiquid.

Interest rate risk

The prices of bonds move in the opposite direction with interest rates. Therefore, fluctuations in interest rate will affect the holding of bonds. If current interest rates are higher than the coupon rate, it means the coupon payments for the bond are lower and this is less attractive to investors. This will therefore lead to a drop in the value of the bond and vice versa.

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