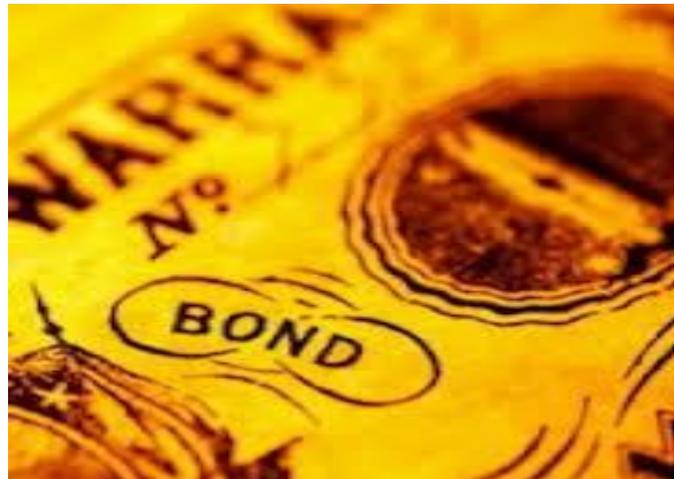


Bond



Bond Overview

A bond is a debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. The Federal government, states, corporation, and many other types of instrument sell bonds.

Generally, a bond is a promise to repay the principal along with interest (coupon) on a specified date (maturity). Some bonds do not pay interest, but all bonds require a repayment of principal.

A bond might be sold at above or below par value (the amount paid out at maturity), but the market price will approach par value as the bond approaches maturity. When an investor buys a bond, he or she becomes a creditor of the issuer. However, the buyer does not gain any kind of ownership right to the issuer, unlike in the case of equities. On the other hand, a bond holder has a greater claim on an issuer's income than an equity holder in the case of financial distress (this is true for all creditors).

Types of Bonds

There are millions of different bond issues, but there are only a few types of bonds. The large majority of bonds fall into one of the three categories of bonds outlined below.

Federal Government Bonds: These are bonds issued by the Federal Government of a country. This type of bond is sometimes referred to as treasury. They are considered risk-free credit risk, and as such the yield from it could act as benchmark at which all other types of bonds can be compared. Bonds issued by the federal government are usually considered the safest bond since the possibility of the government defaulting on payments is almost zero.

State/Local Government Bonds (Municipals): This is a debt security issued by a state, municipality or county to finance its capital expenditures. Municipal bonds are exempt from federal taxes and from most state and local taxes, especially if you live in the state in which the bond is issued.

Corporate Bonds: This is a debt security issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations. In some cases, the company's physical assets may be used as collaterals to the bond. They are considered higher risk than government bonds. As a result, interest rates are always higher, even for top-flight credit quality companies.

Characteristics of Bonds

All of the characteristics of bond play a role in determining the value of a bond and the extent to which it fits in a portfolio. The characteristics include:

1. **Face Value (Par Value):** The face value (also known as the par value or principal) is the amount of money a holder will get back once a bond matures. A bond's price fluctuates throughout its life in response to a number of variables. When a bond trades at a price above the face value, it is said to be selling at a **premium**. When a bond sells below the face value, it is said to be selling at a **discount**.
2. **Coupon (The Interest Rate):** The coupon is the amount the bondholder will receive as interest payments. It's called a *coupon* because sometimes there are physical coupons on the bond that you tear off and redeem for interest. However, this was more common in the past. Nowadays, records are more likely to be kept electronically. Bonds pay interest every six months. The coupon is expressed as a percentage of the par value.
3. **Maturity:** The maturity date is the date in the future on which the investor's principal will be repaid. Maturities can range from as little as one day to as long as 30 years (though longer terms than these have been issued). A bond that matures in one year is much more predictable and thus less risky than a bond that matures in fifteen years. Therefore, in general, the longer the time to maturity, the higher the interest rate.
4. **Issuer:** The issuer of a bond is a crucial factor to consider, as the issuer's stability is your main assurance of getting paid back. For example, the Federal Government of Nigeria is far more secure than any corporation. Its default risk (the chance of the debt not being paid back) is extremely small - so small that Federal Government securities are known as risk-free assets. The reason behind this is that a government will always be able to bring in future revenue through taxation. A company, on the other hand, must continue to make profits, which is far from guaranteed. This added risk means corporate bonds must offer a higher yield in order to entice investors

Bond Rating

The bond rating system helps investors determine a company's credit risk. It is the report card for a company's credit rating. Blue-chip firms, which are safer investments, have a high rating, while risky companies have a low rating. Rating of bonds is done by Rating Agencies like Standard and Poor, Moody's, Agosto & C, GCR, etc.

Benefits of Investing in Bonds

Many personal financial advisors recommend that investors maintain a diversified investment portfolio consisting of bonds, stocks and cash in varying percentages, depending upon individual circumstances and objectives. Whatever the investment goals are, investment advisors can help explain the investment options available, taking into account the income needs and risk tolerance of the individual. The following are the advantages of investing in bonds:

- Regular income
- Tax savings
- Stability
- Capital appreciation
- Preservation of capital
- Diversification of funds

How to Invest in Bonds?

There are several ways to invest in bonds, including purchasing individual bonds or investing in bond funds or unit investment trusts.

Individual Bonds

Most individual bonds are bought and sold in the over-the-counter (OTC) market, although some corporate bonds are also listed on the Stock Exchange. The OTC market comprises securities firms and banks that trade bonds; brokers or agents, who buy and sell bonds on behalf of customers in response to specific requests; and dealers, who keep an inventory of bonds to buy and sell.

If you are interested in purchasing a new bond issue in the primary market (when it is first issued), your investment advisor will provide you with the offering document, official statement or prospectus. You can also buy and sell bonds in the secondary market, after they have already been issued in the primary market.

Usually, bonds sold in the OTC market are sold in N10,000 denominations. In the secondary market for outstanding bonds, prices are quoted as if the bond were traded in N100 increments. Thus, a bond quoted at 98 refers to a bond priced at N98 per N100 of face value, which equates to buying a bond with a face value of N10,000 for N9,800 (at 98 percent).

Bond prices in the secondary market normally include a markup, which consists of the dealer's costs and profit. An additional commission may be added if a broker or dealer has to locate a specific bond that is not in its inventory. Each firm establishes its own prices, within

the regulatory guidelines, which will vary depending upon the type of bond, size of the transaction, and service the firm provides.

Bond Funds: Bond funds, like stock funds, offer professional selection and management of a portfolio of bonds for a fee. Through a bond fund, an investor can diversify risks across a broad range of issues and opt for a number of other conveniences, such as the option of having interest payments either reinvested or distributed periodically.

Like individual bonds and other investments, bond fund investments entail risk. Investors should not automatically conclude that a fund offering a higher rate of return or income is better than a fund offering lower rates of return or income. Investors need to be aware of several factors, including the total costs, credit quality, manager quality, risks and the ability to exit these funds before making investment decisions.

Money Market Funds: Money market funds refer to pooled investments in short-term and of high liquidity. These securities include short-term government bonds, certificates of deposit issued by commercial banks, and commercial paper issued by corporations. Generally, these funds consist of securities and other instruments having maturities of three months or less. Money market funds may offer convenient liquidity, since most allow investors to withdraw their money at any time. The minimum initial investment is usually ten thousand naira (N10,000).

Bond Unit Investment Trusts: Bond unit investment trusts offer a fixed portfolio of investments in government, municipal, mortgage-backed or corporate bonds, which are professionally selected and remain constant throughout the life of the trust. One of the benefits of a unit trust is that you know exactly how much you will earn while you are invested because the composition of the portfolio remains stable. Since the unit trust is not an actively managed pool of assets, there is usually no management fee, but investors do pay a sales charge, plus a small annual fee to cover supervision, evaluation expenses and trustee fees. The trust typically ends when the last investment matures.

Key Bond Investment Considerations

Assessing Risk

All investments carry some degree of risk, which is linked to the return that investment will provide. A good rule of thumb is the higher the risk, the higher the return. Conversely, safer investments offer lower returns.

Variables of Risk

There are a number of key variables that comprise the risk profile of a bond: its price, interest rate, yield, maturity, redemption features, default history, credit ratings and tax status.

Interest Rate: Bonds pay interest that can be fixed, floating or zero coupon.

Maturity: A bond's maturity refers to the specific future date on which the investor's principal will be repaid.

Redemption Features: While the maturity date indicates how long a bond will be outstanding, many bonds are structured in such a way so that an issuer or investor can substantially change that maturity date.

Call Provision: Bonds may have a redemption – or call – provision that allows or requires the issuer to redeem the bonds at a specified price and date before maturity.

Put Provision: A bond may have a put provision, which gives an investor the option to sell the bond to an issuer at a specified price and date prior to maturity.

Conversion: Some corporate bonds, known as *convertible bonds*, contain an option to convert the bond into common stock instead of receiving a cash payment.

Yield: A bond's yield is the return earned on the bond, based on the price paid and the interest payment received.

The Link Between Price and Yield: the price of fixed rate bonds fluctuates according to changes in the market interest rates. Prices for fixed rate bonds move inversely with changes in interest rates. Market interest rate movements have a larger impact on the price of bonds with a longer remaining period to maturity.

The Link Between Interest Rates and Maturity: the longer a bond's term, the more its price may be affected by interest rate fluctuations and investors will expect to be compensated for taking that extra risk.

Default: Default is the failure of a bond issuer to pay principal or interest as at when due.

About GMA

GMA is duly registered with the Securities & Exchange Commission (SEC) in Nigeria as an Issuing House, Financial Advisers and Fund Managers and it is also a member of Asia Pacific Real Estate Association (APREA) that deals with all manners of listed real estate instruments.

Goldbanc Management Associates Limited (GMA) has opened up new frontiers in the provision of financial services through professionalism and delivery of unparalleled value-added services. One of the cardinal goals of GMA is to provide unbeatable customized investment solutions for institutional investors, corporations and high net worth individuals in response to the prevailing financial market conditions and expand the horizon of options for channeling resources towards wealth creation.

Our keen focus on Africa is based on our extensive experience and tested expertise in key economic sectors, coupled with our working relationship with various international portfolio management companies. This has enhanced our capacity in risk management, given us access to funds and enabled us to offer personalized services to our clients.

GMA has been able to establish a strong presence in virtually all the segments of the market in which it operates in Nigeria and other African countries.

GMA has taken pride in some of its landmark transactions such as cross -border listing of a South African-based company Pinnacle Point Group Plc on the floor of Nigerian Stock Exchange and structuring first African Real Estate Investment Trusts (REITs) for Union Homes Plc.

Our financial/investment advisory services have been extended to clients in Tanzania and our real estate development and assets management services are also available in South Africa.

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