Bonds: **They can do a portfolio good.**

A bond represents a debt instrument whereby a lender (investor) loans money to a business or government in exchange for a fixed interest payment (usually paid semi-annually) over a fixed period of time. Seems simple enough. However, confusion can set in when a discussion on bonds goes beyond the basics. When someone who really knows their stuff starts talking about bonds, the dialogue can not only seem technical, but quite foreign as well. This is why bonds are viewed by some investors as the ugly cousin of stocks. Despite all their great qualities, some people just don't want to get to know them.

But since bonds can play an important role in a portfolio, especially for those investors who are looking to draw income or reduce their portfolio's volatility, it's important to understand how they work. It doesn't need to be complicated; a good grasp of the basics is all you need. Consider our sample bond as reference:

Issuer	Par Value	Coupon	Maturity Date	Price	Yield
Royal Bank	$100,000	5.750%	09/30/2012	97.00	6.42%

- A bond's par value, interest rate (coupon) and maturity date are established at the time of issuance, and they don't change throughout the life of the bond (except in unique circumstances).
- After issuance, bonds are bought and sold on an open market, and their prices can fluctuate daily, just like stocks. Bond prices are quoted as a percentage of their par value – if a bond has a par value of $100,000 and is trading at 97, it would cost $97,000 to purchase.
- A bond's *yield* is best thought of as its return, expressed as an annual percentage. There are numerous definitions of yield, but the one that is most commonly referred to is *yield to maturity*. This is the annual return that you would receive on a bond if you held it until maturity.
- A bond's return is made up of the interest that it pays out, as well as any gain or loss in its price.
- While a bond's price in the market is affected by a number of factors, *credit risk* and *prevailing interest rates* are the most important.
    - Credit risk refers to the risk that the issuer of a bond will not be able to make their interest payments on time and in full. Borrowers who are perceived to have greater credit risk must compensate lenders by offering their bonds at higher interest rates.
    - Prevailing interest rates refers to the rate of interest that a particular type of borrower (e.g., the government) would have to pay a lender if they wanted to issue a new bond.
- Now for the confusing part: When interest rates rise, bond prices fall, and vice versa.
    - Consider you hold a Government of Canada bond that you bought for $100 and that pays 5% interest. If the government issues new bonds that pay 6% interest, your bond will fall in value (all other things being equal), as no investor would be willing to pay $100 for your lower stream of interest payments. To attract buyers, you would have to sell your bond at a discount, say $95, to compensate for the lower interest payments.

The Steadyhand Income Fund is comprised of bonds with varying yields, maturities, and levels of credit risk to provide you with a diversified pool of income-generating assets. While they may not be as sexy as stocks, bonds can do a portfolio good. Give us a shout if you want to discuss how they may fit into yours.

First published on November 14, 2007, by Steadyhand Investment Funds Inc.