

Bonds are your barometer

Understanding the bond market could be the most profitable way to manage your shares. Honestly.

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Which way are your New Zealand shares likely to trend in the next six months? Going by the movement of the bond market, on the whole, they're likely to remain static, if not go down.

Er, going by what market, did you say?

The bond market. Listen up: it may be the most boring of investment vehicles, but those people serious about managing their own portfolio understand the bond market; and they especially understand how bonds affect the value of their shares. Yet, says Warburg Dillon Read's chief economist Robin Clements, even if New Zealand investors had miraculous powers to predict future bond movements, many would still have major difficulty understanding what it all means.

Fact is, bonds are probably the most commonly misunderstood part of the investment scene, despite bond yields (that is interest rates — see "How bonds work", page 69) being strong predictors of share market performance. For example, here's what one interpretation of the bond market is telling us now. On the basis that 10-year bond yields will rise to 7% later this year, and other interest rates such as the 90-day bill rate will move to similar levels within 18 months, Clements is expecting local equities to largely remain out-of-the-money for some time. These rising bond rates (interest rates) will hit those companies with weak earnings, so once again the safe bets will be with companies showing solid earnings growth. Warburg Dillon Read's equity strategist, Ian Purdy, favours stock that will benefit most from a consumer and tourism-led economic recovery: The Warehouse, Baycorp Holdings, Tourism Holdings, Auckland Airport, Air New Zealand, Telecom, Sky TV and INL.

Equity and bond markets go together like *Tom and Jerry*. When bond yields go up, equities tend to go down. Why? Clements says investors forget that bond yields play a large role in driving company earnings. And of course it's earnings that largely determine share prices. "If every company's true value is a reflection of future cash flow, then as bond yields (that is, interest rates) go up and everything else remains equal, the value of equities goes down." Or to put it simply, a higher interest rate increases the cost of money, which, in turn, increases the cost of doing business. Increased costs mean lowering the true value of the business, which affects perceived value of the company and so on.

Take, for example, the recent moves in the US markets. Following a hint from that country's federal reserve chairman, Alan Greenspan, that interest rates would rise, the Dow Jones equities index dropped 200 points and US bond yields rallied. Clements expects over-stretched US equity values to continue to fall under sustained interest rate pressure.

Where to from here for bonds and interest rates, then? Many market analysts believe there will be increases in bond yields both here and in the US before this year is out. But Clements doubts whether the recent rally in bond yields is sustainable long term. He expects New Zealand money to migrate from both bonds and equities to safer term deposits as Y2K and election-associated and uncertainties feed investor anxiety.

How bonds work

Peter May, head of capital markets at brokerage JB Were & Sons, spends up to 80% of his time explaining to investors how bonds work. He says many investors fail to recognise that unlike term deposits, bond prices move. Yet, he says, it's impossible to invest sensibly in bonds without understanding how they're priced.

So here's a user's guide.

A bond is a fixed interest loan that you, the bond holder make to an institution, for example, the government.

Bond holders are given a coupon, that is, an annual income of pre-set interest payments, say an annual 8% payment on a \$10,000 bond set to mature in July 2002. The coupon rate remains the same through the life of a bond. "But what investors don't realise is that a bond's market value moves with interest rates and anyone investing in bonds ideally wants to invest while interest rates are high," says May.

After the original tender, the bond becomes part of the secondary market where private investors can buy and sell bonds. It's this secondary market where the bond's true value is determined — often bearing little relevance to its face value (\$10,000). Those who exit early can find themselves with less or more capital than they started with.

The market value is purely a function of interest rates. As interest rates (that is, bond yields) rise above 8%, the value of our bond falls. Hard to grasp, but it works like this. As the interest rate rises above 8%, money is better spent on higher-interest earning investments — hence bond yields rally. Our 8% bond is now worth less than before. The reverse is also true.

And then there's accrued interest. Coupon payments are generally paid twice a year until maturity. Holders of government bonds maturing on July 15, 1998, would have received coupon payments on January 15 and July 15 and every six months thereafter until maturity, no matter when the bonds were purchased. Meanwhile, between coupon payments, interest accrues daily. This means if the bond is bought or sold during any time other than on coupon payment date, accrued interest will be incorporated in the purchase or sale of the bond.

For example, the government announced a tender for bonds maturing on July 15, 1998 with an 8% coupon. Bids were received from financial institutions with an average yield of 7.5%. This meant the bond had been issued at a premium because the present market interest rates were lower than the coupon rate. One month later an investor wished to buy \$10,000 face value and the market interest rate (yield) was 7.2%. The cost was:

Capital value: \$10,268; accrued interest: \$67; total: \$10,335.

Two years later, the investor requires cash and wishes to sell. Interest rates have fallen and the yield is now 6.0%, hence the proceeds are:

Capital value: \$10,356; accrued interest \$67; total: \$10,423.

The end result? A capital gain of \$88 has been made and interest income of \$1600 received.

But had yields risen, a capital loss would have been incurred. If the stock was not sold, but held until maturity, the principal face value of \$10,000 would have been repaid.