Introduction to Bonds

What are bonds?

Bonds represent loans to an entity (such as a government or corporation) in which the entity promises to repay the bondholders or note-holders the total amount borrowed.

That repayment in most cases is made on maturity although some loans are repayable in installments. Unlike shareholders, holders of bonds and notes are not owners of an entity, but its creditors.

In return for the loan, the entity will usually compensate the bondholders or note-holders with interest payments during the life of the bond or note. The interest rate on bonds and notes can be a fixed or floating rate.

Coupon rate

It is the stated annual rate of interest that the issuer pays on the principal to the holder of the bond. Coupon types can be divided into fixed rate, floating rate and zero coupon.

Other conditions

A bond may be callable meaning that the issuer may redeem the bond before it matures. A bond may also be convertible which gives the holder the right to convert the bond into a specified number of shares in a company. In certain cases, issuers may have the right to convert a bond if certain pre-determined conditions are met.

Benefits of investing in bonds

1. Stable and Predictable Interest Payments

Investment in bonds provides a return of capital at maturity and usually periodic interest payments that tend to be higher than the interest payments available on bank deposits.

2. Flexibility and Convenience

Bonds listed in Hong Kong are traded on or off the Stock Exchange and investors may buy or sell them according to their financial needs.

Points to Note

1. Price of a Debt Security

If investors wish to buy and sell their bonds prior to maturity, they should be aware of the potential fluctuations in debt prices. Similar to other types of securities, bond prices fluctuate in response to the forces of supply and demand.

2. Interest Rate

The price of a fixed rate debt security usually moves in the direction opposite of market interest rates. If interest rates go up, the price of the debt security will, other factors being equal, go down, thereby increasing the current yield (the annual interest payment divided by the price of the debt security) and bringing it into line with the higher coupon rates offered by new debt issues.

3. Time to Maturity

As a general rule, when there is a long time to maturity (the date on which the borrower must pay back the principal), the price of the bond is likely to be more volatile because the longer the time, the greater the risk.

4. Credit Rating

Investors should note that the payment of the interest and the repayment of the principal are subject to the credit risk associated with the issuer or the guarantor.

5. Yield to Maturity

The yield to maturity on a debt security is the internal rate of return an investor will receive by holding the security to maturity. It takes into account the sum of the interest payments, the redemption value at maturity and the purchase price. In general, the longer the time to maturity and the lower the credit rating of the issuer, the higher will be the yield to maturity.

6. Overall Market Conditions

As with all investments, returns on a debt security are influenced by factors such as the rate of inflation, unemployment rate, economic growth, balance of payments data, retail sales, industrial production and political changes etc.

7. Exchange Rate Risk

For a bond denominated in a currency other than Hong Kong dollars, Hong Kong investors may suffer losses due to changes in exchange rates.

8. Liquidity Risk

In Hong Kong, investors tend to buy and hold bonds until their maturity. Therefore, liquidity for many bonds in the secondary market may be low.

9. Bond Issue Terms

It is important that investors pay attention to the terms of the issue, e.g. a bond may be redeemed/called before maturity

Examples of Debt Securities traded on HKEx

1. Corporate Bonds

2. Convertible Bonds

3. Exchange Fund Notes (EFN)