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FinancialQuotient

What are bonds?

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WHAT DOES IT MEAN?

Bonds are one class of financial assets that provide periodic coupon payment throughout the life of the bonds. The face value of bonds will be returned to the investors at maturity.

Investors can purchase bonds either from the exchange directly or from some intermediaries, such as brokerage houses or specialised bond trading platforms.

Issuers of bonds can be governments, government agencies, corporates and financial institutions.

The denomination can be either in local currencies or in popular ones, such as the United States dollar, euro or Japanese yen. In Singapore, bond investors are exempted from tax on the coupon payment received.

WHY IS IT IMPORTANT?

Bonds offer several benefits to investors. First, they provide reasonable diversification benefits to enhance the returns if investors hold both bonds and stocks. This is because stocks and bonds are usually not highly correlated and the combination of the two assets would reduce the risk without compromising investment returns.

Hence, for buy-and-hold investors, bonds can be a reasonable financial asset in addition to stocks.

Second, bonds offer predictable income for investors who demand regular payment from their investment. This type of payout structure is preferred by retirees who need regular cash payouts. Dividends from stocks can be more unpredictable and volatile than coupons.

Third, bonds are safer than stocks if investors are more risk-averse. This is represented by lower volatility in the price fluctuation of bonds compared with that of stocks. Among different types of bonds, government bonds in Singapore are among the safest financial assets in the world.

Undoubtedly, lower risk is also accompanied by lower return. For example, the benchmark 10-year Singapore Government Bond (with maturity on May 1, 2028) has a coupon rate of 2.625 per cent. Its daily price volatility has been at 0.77 per cent since issuance in May last year.

In comparison, the total return for individual stocks ranged from minus 36.3 per cent to 15.1 per cent from January to October last year.

Nevertheless, bonds are much less liquid than stocks in Singapore as the vast majority of bonds are traded over the counter (that is, not on the Singapore Exchange). If liquidity is a concern for investors, they should set a cap on how much capital to put into bonds.

IF YOU WANT TO USE THE TERM, JUST SAY:

"Bonds offer good diversification benefits for investment return enhancement and stable income for those investors who prefer a more balanced portfolio."

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