

Fixed Interest Investments

Fact Sheet



Redmayne
Bentley

When a government or company wishes to raise capital, they can issue a bond. Typically, the bond will be created with a nominal value, a coupon and a maturity date. Investors buying the bond are lending the company, or government, money on the assumption they will receive a periodic interest payment and the nominal value back when the bond 'matures'. For example; an investor invests £6,000 in a bond priced at £120 (per £100

nominal), on maturity the investor receives the nominal amount back - being £5,000. Similarly the investor receives the nominal value back even if they have invested in a bond trading below par (i.e. below £100 nominal), therefore realising a capital gain on redemption. Always remember the promised payment of income and the return of capital could be in jeopardy in the event that the issuer has problems meeting its financial obligations.

WHAT DOES 'FIXED INTEREST' MEAN?

Fixed interest investments pay a fixed rate of interest or dividend on an annual or semi-annual basis. The interest is determined by the **coupon** (the gross interest rate of the nominal value, expressed as a percentage, i.e. the holder of 5% Treasury 2028 is entitled to £5.00 interest annually for every £100 nominal held). The main factors influencing the bond market are as follows:

- **Interest Rates** - This is an important factor as one reason investors buy bonds is because of the fixed interest payment. If interest rates rise the bond will be less attractive as other investments could offer a better return.
- **Coupon** - A bond (or fixed interest stock) with a smaller coupon will have a more volatile price.
- **Time to Redemption** - The majority of fixed interest vehicles have a limited life, and are redeemed at a given date in the future. The longer the asset has to redemption, the more volatile the price will be. Fixed interest stocks close to redemption will trade around their nominal value (£100, also known as 'par') and will have what is termed a 'pull to redemption'.

WHAT ARE THE DIFFERENT TYPES OF FIXED INTEREST INVESTMENTS?

Government Stocks (Gilts)

Gilt-edged securities are issued by the government. Two types of Gilts exist - Conventional Gilts, (which pay semi-annual interest from a fixed coupon and are redeemed at par) and Index-Linked Gilts, which take into account rises in inflation. The Conventional Gilt market currently shows the majority of Gilts trading above par, or £100 nominal. Investors should expect to see a fall in capital on redemption if they buy the stock above par value.

With Index-Linked Gilts, the coupons are very low with their value linked to the Retail Price Index (RPI) and should be considered when inflation is high or set to rise strongly.

Corporate Bonds

Relative to Gilts, the UK Corporate Bond market is much smaller with individual companies issuing their own corporate debt. As with Gilts, the stocks normally have a redemption date and are redeemed at par. Generally, there is less liquidity in the corporate bond market and the credit rating of the underlying company will have an influence on the security of the loan. There are three main types of Corporate Bond - **Debentures**, which are secured by a fixed or floating charge, e.g. land; **Loan stocks**, which are unsecured; and **Subordinated Loan stocks**, which rank below all other creditors and, therefore, generally have higher coupons.

In 2010 the London Stock Exchange launched the Order book for Retail Bonds (ORB) which offers investors continuous two-way pricing on UK Gilts and retail-sized corporate bonds. Most conventional UK corporate bonds typically trade with substantial minimum investment amounts (c. £50,000), however, since the launch of the ORB, retail investors have seen an influx of new 'retail-friendly' issues which trade with much more accessible minimums.

Eurobonds

A Eurobond is a debt security issued in a different currency than the one of the country in which the bond is issued, and underwritten by a syndicate of international banks. Interest is paid gross and most pay annually, and are usually purchased in £1,000 nominal blocks. The main advantage over the UK corporate bond market is that there are several issues with a high credit rating and investors can purchase debt of leading companies based overseas e.g. BMW and Toyota. Eurobonds must be held in a Nominee account or ISA with Redmayne Bentley as no certificates are issued.

OTHER FIXED INTEREST INVESTMENTS

Preference Shares

Preference shares are shares in a company paying a fixed net dividend. It must be paid before there can be any ordinary dividend payment. With **cumulative** preference, the right to any unpaid dividend continues indefinitely and no dividend can be paid on lower ranking capital e.g. ordinary shares, until preference shareholders receive the arrears in full. For **non-cumulative** holders, if the dividend is not paid, it is lost forever. The main driver behind preference shares is interest rates, as usually the shares are irredeemable and, therefore, not affected by the pull to redemption. Dividend dates are semi-annual.

Permanent Interest Bearing Shares (PIBS)

These are fixed interest vehicles issued by building societies making semi-annual payments. They are irredeemable and would rank last if the company was wound up. Interest is paid gross and normally the minimum investment is £1,000 and must be bought in round £1,000 blocks. There is no protection for holders of PIBS in case of default, as they are not covered by the building societies protection fund. PIBS issued by building societies, which have converted to banks, are called Perpetual Subordinated Bonds (see also the *PIBS Fact Sheet*).

Please note Preference Shares & PIBS can be held in a Redmayne Bentley ISA, along with Gilts and Bonds.

Investments can fall as well as rise in value and you may lose some or all of the amount you have invested. The payment of income and the return of capital could be in jeopardy in the event that the parent company has problems meeting its financial obligations. Tax treatment depends on the specific circumstances of each individual and may be subject to change in the future.
