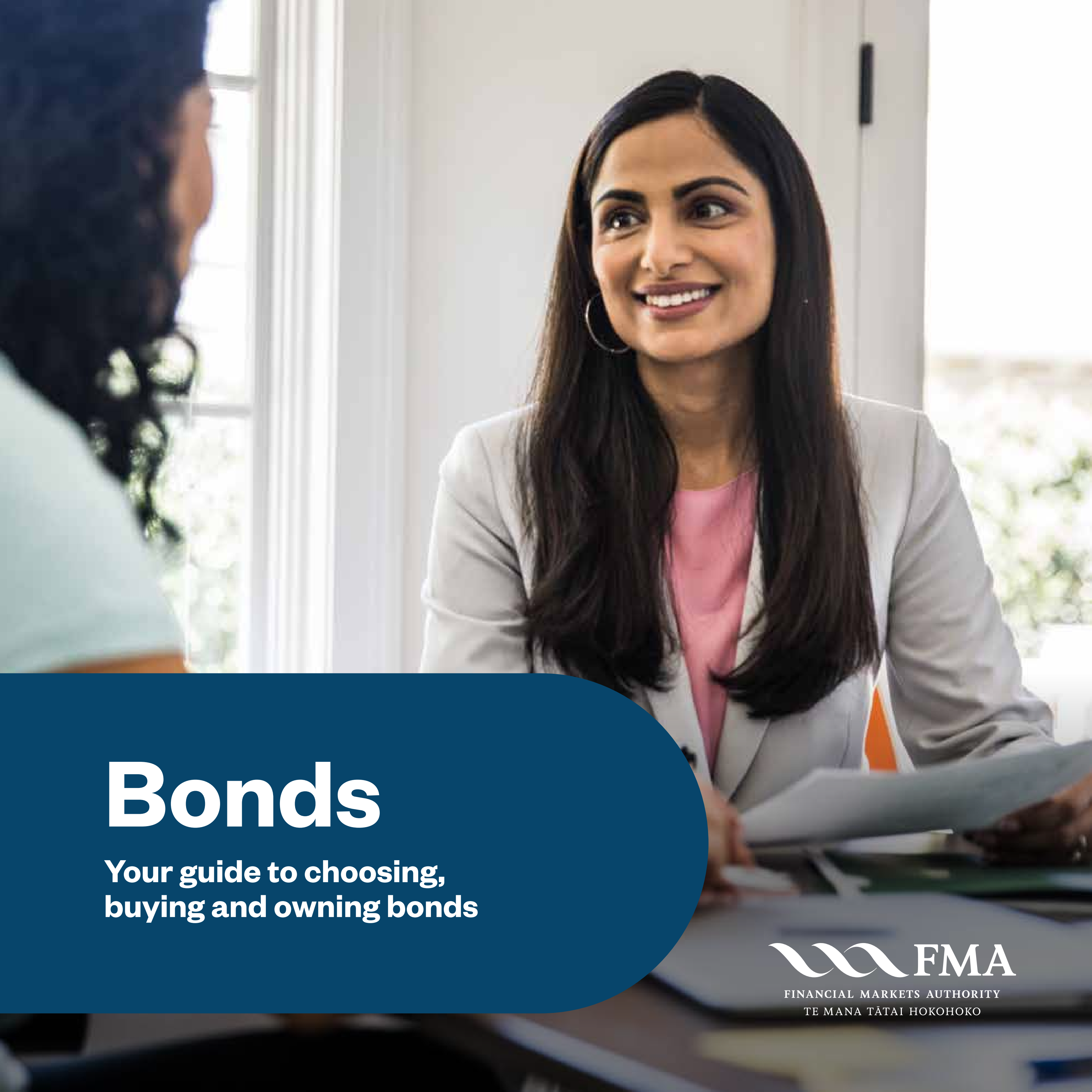


Bonds

Your guide to choosing, buying and owning bonds

FMA

FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Contents

Issuers of bonds are subject to a number of obligations under New Zealand law, including rules around the information that must be disclosed to investors. The FMA plays a key role in monitoring and enforcing this area.

What are bonds?

One way that a government, a council or a company can raise funds is through issuing bonds to investors.

By buying a bond, you are essentially lending money to the organisation issuing the bond (the 'issuer') for a fixed period of time. In return for your investment, the issuer generally promises to pay you:

- regular interest rate payments (coupon payments) over the term of the bond until maturity;
- a fixed amount of money (the face value, or principal) if you hold the bond until its maturity date.

Bonds are a type of fixed interest investment. They are a good way to spread the risk in your investment portfolio, as they generally offer more stable returns, and can be lower risk than growth investments such as shares.

One reason is because, under company law, if a company collapses, bondholders are paid out before shareholders.

However, bonds still have risks.

A key factor influencing how much risk a bond has is who the issuer of the bond is. For example, government bonds will be less risky than bonds issued by a company with an unstable financial position (which might become insolvent before maturity and unable to pay you what you're owed).

What's in a name?

Not all bonds are called 'bonds'. The name of the bond type will often give you clues about its risk.

Name	Risk
Government, council and corporate bonds	Risk depends on the creditworthiness of who is issuing the bond (the issuer). Government bonds have the highest creditworthiness and therefore the lowest risk.
Debentures, secured and unsecured notes	Often carry more risk. Fixed interest investments issued by companies such as finance companies and non-bank deposit takers. Riskiness depends on the creditworthiness of the issuer.
Capital notes and hybrid securities	Complex products issued by banks and other companies. Many have features closer in nature to shares. Typically these products are riskier than simple deposits from the same issuer.

Is investing in bonds right for you?

Before you make any investment, it's important to consider your personal situation and why you're investing.

Having a diversified mix of assets, including cash, bonds, property and shares, is one of the basic rules of investing because you spread your risk across a range of investments.

Investing directly in bonds is most suitable if:

You want a predictable and steady income stream

You will receive coupon (interest) payments at regular known intervals (e.g. twice a year) over the bond's lifespan.

You are looking for a relatively low risk way to preserve some or all of your capital while investing

If the bonds are held to maturity (and the issuer is still solvent), you will generally get back the face value, so bonds can be a way to preserve your capital.

You understand the risks

If market interest rates increase, the value of your bond may decrease, with bonds of greater maturity hit harder.

Other factors such as inflation should also be considered. If the issuer of the bond goes out of business or becomes insolvent, you may not get paid your coupons or your principal (face value amount). You can look at the strength of the organisation issuing the bonds by looking at its credit rating and reviewing its most recent financial statements.

A low credit rating = higher risk. You should also consider if the bond has features which make it a less risky investment, such as security over assets.

You understand how risk and return interact

The price of a bond issued by a high risk organisation will typically be lower, and will give a higher yield, than a bond issued by a reputable, stable organisation. The lower price/higher yield reflects the greater risk.

You have time to do the research

You will need to understand the basic features of the bond that you are interested in. You will also need to consider if the bond coupon payments and the bond maturity date align with your cash flow and investment requirements.

You may need your money before maturity

- If a bond is traded on a secondary market you can offer your bond for sale before its maturity date.
- This may be particularly useful if the bond has a long-dated maturity date. For example, some government bonds have maturities of up to 30 years.

There is more information on these topics later in this guide.

If you want to invest in bonds, but don't have time or interest in managing individual bonds, a managed fund or Exchange Traded Fund (ETF) is worth considering.

When you invest in a managed fund or ETF, your money is pooled with other investors and a manager invests in a range of bonds as part of a diversified investment fund.

How much money will you need to invest?

There is usually a minimum amount to invest – typically $5,000 or $10,000, with increments of $1,000 above that.

If you invest in bonds through an ETF, the minimum investment is normally the price of one share – this can be as little as $50, depending on the ETF.

How are bonds different from other investments?

	Term deposits	Bonds	Shares
Minimum investment	Typically start at $1,000 but some rates require higher minimums.	Typically $5,000 minimum but much lower if investing through an ETF.	No set amount but you may need to buy a minimum number of shares which can be quite low if using an online share investing platform.
Type of security	'Debt security' – you have a right to be repaid money by the institution.	'Debt security' – you have a right to be repaid money by the issuer (which might be a government, council or company).	'Equity security' – you have ownership in the company.
Return	Known at the time of investment. Principal and interest at maturity.	Regular coupon payments known at the time of investment. There is potential for capital gains if values increase and you sell the bond before maturity. The overall return is known if you hold the bond from the time you buy it until its maturity date.	Unknown at the time of investment. Dividend payments at the issuer's discretion based on company performance. Capital gain if you sell your shares for a profit.

	Term deposits	Bonds	Shares
Interest rates	Linked to the level of the Official Cash Rate, the term of the deposit and the creditworthiness of the deposit taker.	Varies dependent on the creditworthiness of issuer and the term of the bond.	N/A
Riskiness of investment	Relatively low for bank term deposits, but ultimately risk is linked to the financial strength of the institution. Finance companies that take deposits can be much riskier than banks, which is why they often offer higher interest rates – to compensate for the higher risk that the depositor might not get their money back.	Varies depending on the creditworthiness of the issuer. Creditworthiness and credit ratings of issuers can change as an issuer's performance, risk and prospects change. Bond prices can decline when inflation (and therefore interest rates) rises.	Medium to high, depending on the issuer. The movement of share prices is difficult to predict and prices can be volatile.
Ability to exit investment prior to maturity	Limited – you may need to pay break costs to exit early.	May be able to sell on markets like the NZX Debt Market.	Generally can be sold on markets like the NZX.

What are Kiwi Bonds?

Kiwi Bonds are similar to a term deposit. They offer a fixed rate of interest for a given term. They're issued by the New Zealand Government and have a very strong credit rating.

Kiwi Bonds are available in a range of maturities, including 6 months, 1, 2 and 4 years, and are offered directly to the public by the debt management office of the New Zealand Treasury. They're only available to New Zealand residents.

Kiwi Bonds are a government-backed financial instrument, with a relatively low default risk, so generally offer a lower interest rate than that offered by banks.

How do you make money from bonds

1. Receiving coupon payments

You'll receive regular interest or 'coupon payments' during the term of your bond, until maturity.

Consider this example where you buy a bond on its issue date of 1 January 2020. The bond has a face value of $10,000 and a 5.0% coupon rate. Coupons are paid twice a year for a five year term, with maturity on 31 December 2024. You decide to hold the bond until its maturity date.

You pay the issuer:

- The $10,000 face value to buy the bond on 1 January 2020.

In exchange the issuer promises to pay you:

- $250 coupon payments every six months for five years, and
- The $10,000 repayment of the face value on 31 December 2024, the maturity date.

You'll receive returns of $2,500 (10x $250 coupon payments) over the term of the bond.

Tip: The rate of inflation can influence whether you are getting real value from your coupon payments. Inflation refers to the general increase in prices over time, and a fall in the purchasing power of money. High inflation can result in the purchasing power of your coupon payments decreasing over time. For example, if you hold a bond paying a 1.5% coupon rate and inflation is 2.5%, your return in real terms is negative (-1%) when adjusted for inflation.

What are inflation indexed bonds?

If you're concerned about protecting the 'real' value of your savings, you could consider Inflation Indexed Bonds (IIBs).

These link returns to the rate of inflation by adjusting the bond's principal amount in line with movements in the Consumer Price Index. They have a fixed coupon rate which is applied at each coupon date to the adjusted principal amount.

New Zealand Dollar inflation-indexed bonds are issued by the New Zealand Government.

2. Sale of the bond on the secondary market for a profit

The market value of a bond on the secondary market can change over its term, and can differ from its face value. If you decide to sell your bond on the secondary market early (before the bond maturity date), the potential for profit (or loss) will depend on factors such as:

- How many coupon payments are left (ie amount of time until the maturity date).
- Whether market interest rates have risen or fallen – if interest rates have fallen and your bond is still paying a higher coupon rate, it'll be more attractive to other investors.
- Improvements in the credit rating of the organisation issuing the bond.
- How easy it is to sell your bond on the secondary market (liquidity). If there is not enough activity in the secondary market, you may have to sell your bonds cheaply to attract a buyer.
- Changes in demand and supply for the bonds. The bond value is likely to fall if the issuer starts issuing more bonds than the market can absorb. Conversely,the value is likely to rise if a bond becomes more popular with investors or a new entrant starts purchasing a lot of bonds.

Using the same scenario as above, let's say you sold your bonds on the secondary market on 31 December 2020, one year into the five year term of the bond. Because of falling interest rates, the market value of your bond increased to $10,100 at date of sale.

You paid the issuer:

- The $10,000 face value to buy the bond on 1 January 2020, the issue date.

You received from the issuer:

- Two $250 coupon payments, on 31 May 2020 and 31 December 2020, the coupon payment dates.

You received from the buyer of the bonds:

- $10,100 market value of the bond on 31 December 2020, the date of sale on the secondary market.

You received $600 return ($500 in coupon payments + $100 profit from sale) from the bonds.

You can also lose money on bonds

You can lose money on a bond if you sell it before the maturity date for less than you paid for the bond, or if the company issuing the bond fails or becomes insolvent. In this case the company may not be able to pay you the coupon or face value payments. Before you invest, understand the risks associated with the issuer of the bond.

Understanding Yield to Maturity

Yield to maturity (YTM) is the best measure of the value of a bond. It is also a good way to compare investing in different bonds.

YTM calculates the average annual return of a bond from the day that you buy it (at market value) until the date of maturity. It assumes that you reinvest coupon payments from the bond at the same interest rate the bond is earning.

You should balance the return you can get against any risks before you make an investment decision – typically, bonds with higher returns will be higher risk.

Where does the word 'coupon' come from?

The word 'coupon' is used because bonds were historically printed as paper certificates with coupons attached. There was one coupon for each date an interest payment was owed. Bondholders cut out the coupons and sent them off to the issuer for payment when the coupon was due.

Bonds are no longer typically issued as paper certificates. Instead digital records are usually kept by registry service companies who know when coupons and principal payments are due, and will ensure these payments are paid automatically to the bond owner's nominated bank account.

Buying and selling bonds

How to buy bonds

You can buy bonds through:

- some financial advisers
- an NZX accredited broking firm
- an online trading website
- directly through the organisation issuing the bonds – via a 'public offer'.

Most commonly you'll need to buy bonds through a broker.

You can find a list of accredited brokers (or participants) at the 'Find a Participant' section of the **NZX website**.

Some brokers are online only and allow you to set up an account yourself, while others have offices you can visit.

Setting up a trading account

You will need to go through a broker's client registration process to open a securities trading account with them. This lets you buy bonds and other investments ('securities') such as shares.

If you are registering to buy and sell bonds for the first time, the broker will arrange for you to be assigned with a:

- **Common Shareholder Number (CSN)**, which is used to identify what you own as separate from any others on a central register. A CSN starts with an 'R' and is followed by a nine digit character number.
- **Faster Identification Number (FIN)**, which is a four digit number used to identify you as the unique holder of your bonds. A FIN is similar to a PIN number on your bankcard.

Your CSN and FIN is personal information, you should keep these details private. Both the CSN and FIN are required to trade. Your broker cannot execute a trade without one of these numbers.

How your trades are recorded

Whenever your broker buys or sells bonds on your behalf, or if you trade for yourself online, you should receive a 'contract note' or a similar confirmation document. This is a legal record of the transaction including all relevant details such as the bond issuer, the amount bought or sold, the price or yield, the bond maturity date, the coupon rate and the face value amount.

A registry is a company that works on behalf of the organisation issuing the bonds. The registry will provide you with periodic statements to detail your bond holdings. The registry also records ownership of issued bonds and facilitates coupon and principal payments to all bondholders.

What it costs

Fees will vary depending on the type of service you choose. You will typically pay a minimum brokerage fee for each order placed, and may have to pay a percentage fee for any amount over the minimum.

You should expect to pay more if your broking firm is providing additional services, such as sending you company research and helping to select your investments.

How to sell bonds

You can sell bonds in the same way you buy them – typically through a broker.

You can sell bonds on a secondary market at any time between the date they were issued and their maturity date, depending on the liquidity of your bonds. 'Liquidity' refers to how easily you can buy and sell your bonds.

The difference between primary and secondary markets

1. The primary market

This is where the issuer is selling new bonds to investors. The issuer will prepare a Product Disclosure Statement (PDS) that sets out the key terms of the offer, the features of the bond, the risks of investing, and other important information.

2. The secondary market

This is where investors can both sell and buy existing bonds. There are two types of secondary market: listed markets such as the NZX Debt Market (NZDX) and over-the-counter wholesale markets. Both of these types of secondary markets can be accessed by you through a broker.

When you buy a bond in the secondary market you will pay the market value of the bond. This may be higher or lower than the face value of the bond. You will typically also pay transaction fees such as a commission or a brokerage fee.

Deciding which bonds to buy

Some types of bonds are riskier than others, so it's important you do your research before you buy. Here are some points you can consider to help you choose.

Do you understand the type and structure of the bond?

Key areas to consider include:

- **The issuer:** Who is issuing the bond and what is their creditworthiness? Most bonds have a credit rating that takes into consideration the bond issuer's financial strength or its ability to pay the bond's principal and interest when due. Generally, a 'AAA' high-grade rated bond is more creditworthy and less risky and will have a lower yield than a 'B-' rated bond.
- **The term and coupon frequency:** Does the term of the bond fit with your investment goals. Also look at the frequency of the coupon payments. Some offer quarterly coupons – others are twice a year. Take care to compare like with like.
- **Seniority:** Bonds have a seniority ranking. This tells you where the bond sits in the issuer's repayment priority list. Unsecured bonds (or subordinated bonds) rank lower in seniority than secured bonds.
- **Additional and unusual features:** Look for terms such as 'callable', 'convertible', 'or 'perpetual'. If you aren't clear what these mean, seek advice.

Do you understand the key risks?

As you do your research, questions to ask include:

- Will the issuer remain in business until the date of maturity, and be able to pay you the coupon or principal payments on the dates they are due? Credit ratings will help you assess how likely it is that the issuer may fail or become insolvent.
- What are commentators saying about interest rate market movements? This is particularly important if you think it's likely you'll sell your bonds. If interest rates go up, the market value of the bonds will generally fall, and vice-versa.
- What is the liquidity of the secondary market for the bonds? How easy it is to buy and sell the particular bond in the secondary market without affecting the market price. Are there typically prices available every day to buy and sell the particular bond? Good market liquidity helps you avoid the risk you won't be able to sell your bonds on the secondary market quickly and at a reasonable price.
- Can the issuer pay back the bonds early? Some bonds are 'callable' or 'redeemable' which means the issuer can decide to repay you the face value and coupon payments accrued to date, at a date prior to the maturity date. This normally happens when interest rates fall.
- What is the term of the bond? Generally shorter-term bonds are less risky than longer term bonds from the same issuer as the chances of a business failing will typically be less over a shorter period.
- If you're investing in a primary offer or a continuous offer, the Product Disclosure Statement (PDS) will describe the key risks. Make sure you read the PDS carefully. Broker research reports and general market commentary are other ways you can determine these risks.

Do you have a good mix of bonds?

If you've decided to invest a significant proportion of your money into bonds, consider how you can diversify your bond investments. Choosing different types of bonds and bond issuers to build a bond portfolio reduces concentration risk and increases your chance that some bonds will perform well when others don't.

For example, consider buying bonds:

- from issuers across different types of institutions: governments, local authorities, banks and corporates
- from issuers across different companies and industries
- that provide cash flows at different times
- with different maturity dates
- issued by international issuers
- indirectly through an Exchange Traded Fund (ETF).

What is bond laddering?

Bond 'laddering', or choosing bonds with different maturity dates, gives you access to cash at different times. It also reduces the chance that all your bonds mature at a time when interest rates may be high and yields are low – which impacts the money you'll make when you reinvest the principal.

Credit ratings

What's a credit rating agency?

A credit rating agency (such as S&P, Moody's or Fitch) assigns credit ratings to an organisation based on its perceived ability to make timely repayments. Credit rating agencies assess an organisation's financial strength, as well as other factors including the organisation's management team, internal processes and external industry-related issues.

What's a credit rating?

A credit rating is an alphabetical rating assigned to an organisation by a credit rating agency. 'AAA' is the highest credit rating while 'C' is the lowest.

Sometimes a credit rating doesn't apply to the bond issuer, but rather to the bond itself or to the issuer's holding company. See our website for more information on credit ratings.

What does the credit rating mean?

A higher credit rating indicates that an organisation is perceived to have lower credit risk or a lower chance of default, and vice versa. A company rated as 'AAA' has a risk of default of 1 in 600 over five years, while a company rated 'B' is 1 in 5 over five years.

Things to think about:

- Sometimes an organisation might have no credit rating. This doesn't necessarily mean you should avoid the investment, but you should take extra care to assess the risk. You could ask a financial adviser why the organisation has no credit rating, and what the associated risks are. It is often the case that these type of organisations offer higher returns, because of the higher risks.
- Ratings issued by financial advisers could serve as a useful guide, but they should also be treated with caution as these ratings may not be from recognised credit rating agencies.

Keeping track of your bonds' performance

You may not find as much information about bonds in the business news as there is for shares. However there are a number of ways to keep track of the performance of your bonds.

Newspapers

Closing values such as yields are published for some bonds such as government bonds.

Online

If you have an online trading account it should show you how your bonds are performing. You can also view **NZDX (NZ Debt Market)** – listed bond prices (yields) and other information on the NZX website.

Many unlisted bond yields can be found online through a simple search.

Annual reports

Any organisation issuing bonds under a regulated offer must issue financial statements each year.

You will find the report on the company's website or on the government's Companies Office website. See '**How to read a company annual report'** on the FMA website to learn what information is most important – including red flags to look out for.

Check for credit rating changes

Credit downgrades may be a sign you are less likely to get your money back at maturity, or that interest will be paid on time.

Through your financial adviser or broking firm

If you are using a financial adviser or broking firm, they will send you regular updates.

Through a portfolio management platform

This may be provided by your broker or can be accessed or purchased from a software provider.

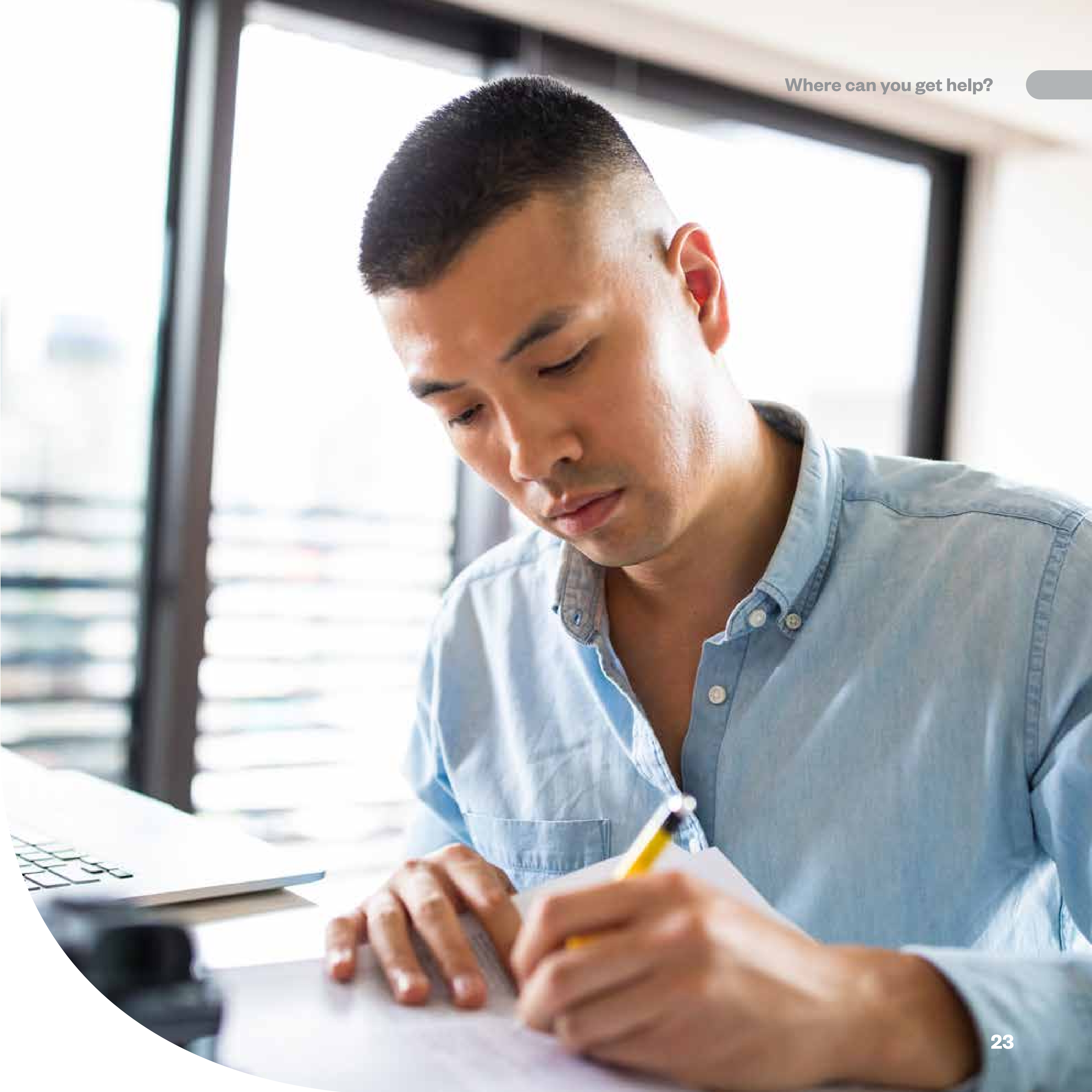
Where can you get help?

If you're just starting out, there are lots of places you can go to find more information.

For example, you could:

- Use the tools and resources provided on the investor pages of our FMA website. These include descriptions of more complex types of bonds such as capital notes and hybrid securities, and information to help you understand the disclosure information bond issuers must provide.
- Join the **NZ Shareholders' Association**, which provides information, education and access to analysis for people managing investments. They help out with information about bonds as well as shares.
- Attend an investor seminar or workshop run by an advisory or funds management firm or by an investing service.
- Use the guides and information produced by your broker.

For advice that takes into account your broader financial situation, you should speak to a financial adviser. See the '**getting financial advice**' pages on the FMA website.



Understanding the jargon

Here are some common terms you may come across when you start investing in bonds:

Bondholder

The investor who has the right to receive coupon and principal (face value) payments from the issuer at the promised dates.

Coupon payment

The interest paid on bonds. It is determined by multiplying the coupon rate by the face value of the bond and adjusted for the number of days in the coupon period.

Coupon rate

The rate of interest paid by a bond issuer on the bond's face value. It is the periodic rate of interest paid by a bond issuer to the owner of the bond. The coupon rate is calculated on the bond's face value (or par value), not on the issue price or market value.

Debt security

The legal term under the Financial Markets Conduct Act 2013 for an investment where you have a right to be repaid the money you invest, or interest on that money, by the issuer (e.g. a bank). Bonds and term deposits are types of debt securities. By contrast shares are 'equity securities'.

Face value (or par value or principal value)

The amount the issuer agrees to pay to the bondholder at the maturity date of the bond.

Frequency

How often the issuer agrees to make coupon payments (and possibly principal payments) to the bondholder. Many bonds with fixed coupon rates pay coupons twice a year (semi-annually) but coupon frequency can be monthly, quarterly, semi-annually or annually.

Issuer

The organisation that is borrowing money by issuing the bonds, and is obligated to make interest and principal payments at the promised dates.

Issue date (or issuance date)

The date that the bond was issued to the bondholder.

Maturity date (or maturity)

The date on which the principal (face value) amount is due for payment.

Term

The original term of a bond is the length of time between the issue date and the maturity date. The current term is the length of time from today to the maturity date. For example, a bond issued with a 30 year term in the year 2000, will have a 10 year term in the year 2020. The term can range from one day to as long as 100 years or more, or even in perpetuity.

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