

Local bonds are an interesting asset class that, for a long time, were unappreciated – and rightly so. But this has all changed. This week I'll first give the basics of what bonds are and how they work for investors, and next week will take a closer look at current market dynamics for SA government bond investors – keep an eye out for that!

For the purposes of this report, I'll focus on local bonds issued by the SA government. Investors into these bonds are essentially loaning money to the government on the condition that they are paid regular interest (a fixed coupon usually twice a year) and then receive their capital back on a pre-determined date. These bonds are guaranteed by the government and, because government can increase money supply to pay off these debts, there is an extremely low possibility that there will be a default (i.e. government won't pay the interest and capital).

These bonds, once issued, trade on the secondary market (much like shares on the JSE) with prices varying as a function of supply and demand. Lower prices equate to higher running yields and vice versa. The below example gives some indication of how the mechanics work on bond investments, without getting too technical or using too much jargon.

Investor A: Buys 10-year bond at a 10% annual yield for R 1 000 000. This investor will receive R 100 000 a year in interest (two R 50 000 coupons annually) and R 1 000 000 at the end of 10 years (i.e. no capital growth) if they hold to maturity.

If, after 5 years, Investor A is in a pickle and needs to liquidate their bond, they find Investor B to trade with on the market.

Investor B: Buys 10-year bond after 5 years (i.e. 5 years until maturity) from Investor A at an agreed R 900 000. Investor B therefore earns a 11.1% annual yield (R 100 000 pa over R 900 000 purchase price) for 5 years and will generate some capital growth as well, as their R 900 000 investment will grow to R 1 000 000 (par value) at maturity.

In this scenario Investor A loses out, and Investor B earns an enhanced return, but the roles could easily be reversed if, at the time of sale, there is increased demand for the bond, and it trades at a premium.

As these bonds have a fixed yield and a fixed maturity it is quite easy to work out what your return will be (ignoring reinvestment risk) if you hold to maturity. If you sell before maturity, you put the capital component at risk (i.e. you may make a capital gain or a capital loss depending on market conditions).

While your nominal return is easy to calculate your real return will be dependent on the inflation rate over your holding period. All else equal, higher realised inflation eats away at your real return and lower inflation enhances your real return. Investors therefore typically require a yield in excess of expected inflation in order to compensate for this risk.

Next week we take a look at the current yield pick-up that one can expect from investing into bonds. Spoiler alert – it is attractive!

Take care,



Mike Browne CFA
Portfolio Manager

What Are Bonds?

DISCLAIMER

Seed Investment Consultants is an Authorised Financial Services Provider in terms of the Financial Advisory and Intermediary Services Act (Act No. 37 of 2002). The laws of the Republic of South Africa shall govern any claim relating to or arising from the contents of this document. This document may not be amended, reproduced, distributed or published without the prior consent of Seed Investment Consultants.

No guarantee is provided as to the values of any financial product mentioned in this document. All illustrations, forecasts, information and opinions provided within this document are of a general nature and are not intended to address the circumstances of any particular individual or entity. This document does not constitute a solicitation, invitation or investment recommendation. While we endeavour to provide accurate and timely information, all illustrations, forecasts or hypothetical data are not guaranteed and are provided for illustrative purposes only. We make no representation or warranty, expressed or implied with respect to the correctness, accuracy or completeness of the illustrations, forecasts, information or opinions. No party should act upon such information or opinion without obtaining the appropriate professional and specialised financial, legal and tax advice based upon a thorough examination of their particular situation. Seed Investment Consultants will not be held liable for any direct or consequential loss or damage suffered by any party as a result of that party acting on or failing to act on the basis of information or opinion provided by or omitted from this document.

The value of financial products can increase as well as decrease over time depending on the value of the underlying securities and market conditions. Changes in exchange rates may have an adverse effect on the value price or income of any product.

Past performance is not necessarily a guide to future performance. Performance has been calculated using net NAV to NAV numbers with income reinvested. The performance for each period shown reflects the return for investors who have been fully invested for that period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestments and dividend withholding tax. Full performance calculations are available from the manager upon request.

Prescient Management Company (RF) (Pty) Ltd are registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. There is no guarantee in respect of capital or returns in a portfolio. CIS's are traded at the ruling price and can engage in scrip lending and borrowing. The CIS may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. CIS prices are calculated on a net asset basis, which is the total value of all the assets in the portfolio including any income accruals and less any permissible deductions (brokerage, STT, VAT, auditor's fees, bank charges, trustee and custodian fees and the annual management fee) from the portfolio divided by the number of participatory interests (units) in issue. Forward pricing is used. In the event that specific CIS in securities are mentioned please refer to the relevant Minimum Disclosure Document in order to obtain all the necessary information in regard to that unit trust. In rare instances redemption transactions may be subject to a redemption fee. The applicable Prospectus and Key Investor Information Document will be made available upon request.

Please note that there are stipulated cut-off times for all documents, notifications of deposit, investment, redemption and switch applications. These cut-off times are product or fund specific and the applicable guidelines have been stipulated on the relevant supporting or transaction documents, application forms and Minimum Disclosure Documents. Where all required and supporting documentation is not received before the stated cut off time no service provider shall not be obliged to transact at the net asset value price as agreed to. Prices are published daily and are available on the Prescient website at www.prescient.co.za.

Investors should at all times remain aware of the risks involved in the buying or selling of any financial product. Where foreign securities are included in a portfolio there may be potential constraints on liquidity and the repatriation of funds, macroeconomic risks, political risks, foreign exchange risks, tax risks, settlement risks, and potential limitations on the availability of market information. The investor hereby acknowledges the inherent risk associated with any selected investments and that there are no guarantees (Paragraph 6(2)(f) of BN92). The Manager retains full legal responsibility for any third-party named portfolio (Paragraph 6(1)(g) of BN92).

For any additional information please visit our website on www.seedinvestments.co.za.