THE Nigerian STOCK EXCHANGE

RC: 2321

BONDS

What is a Bond?

A bond is a debt security (loan) issued by a Government, Governmental Agency, or a Corporation. It is basically an ''IOU'' issued by one party to another. The bondholders (or investors) are the lenders, and the issuer is the borrower. The borrower promises to make periodic interest payments (coupon) as well as repay the original loan (principal) to bond holder on a stipulated date in the future – referred to as the maturity date. The amount of income a bond generates each year is fixed and will not change for any reason – that is why bonds are called **'Fixed Income'** securities.

Types of Bonds

The common types of bonds in Nigeria are:

Federal Government Bonds: These are issued by the Federal Government of Nigeria via the Debt Management Office (DMO) and listed on The Nigerian Stock Exchange (NSE). The income earned on FGN Bonds is tax free.

State/Local Government Bonds: Just like FGN Bonds, there is no Value Added Tax on the proceeds of sale of State and Local Government Bonds and the borrower/issuer in this case is the issuing State, or Local Government. They are also listed on The NSE.

Corporate Bonds: These are issued by private and/or public companies. They normally have higher interest rates than Government Bonds. Some Corporate Bonds can be converted to equity if certain provisions are met - such bonds are called **Convertible Bonds.**

Advantages of Investing in Bonds

1. **Regular Income:** Bondholders are paid interest at a fixed rate until the maturity date.
2. **Tax Savings:** Interest earned on bonds is tax exempt.
3. **Stability:** Fluctuations in bond prices are normally less volatile than that of equities.
4. **Capital Appreciation:** Like all instruments traded in the secondary market, the price of bonds can appreciate (or depreciate) over and above (or below) the initial purchase price.
5. **Predictability:** Bondholders know how much interest they will be paid, when they will be paid and when the principal will be repaid.
6. **Interest:** Bonds pay higher interest rates than savings accounts.

Bond Structure

Fixed-rate- Pay fixed rate at regular intervals over the lifetime of bond until redemption when principal amount is repaid.

Floating-rate- Unlike fixed rate bonds, the coupon or interest rate varies according to particular reference rate, e.g. NIBOR.

Index-linked- Principal and coupon payments linked to index, e.g. inflation- linked bonds linked to consumer retail price index (RPI)

Zero Coupon-No interest paid, return on bond comes from discounted value at which bond is issued compared to final redemption value i.e. the bond is issued at a discount

Convertibles- offer an option to exchange the bond for a preset number of shares of the issue

What will affect the Return on Bonds?

Investors should consider the following factors before Investing in bonds:

i. **Credit or Default Risk**
This is the risk that the bond issuer is unable to pay coupon (interest) or principal to bond holders when they fall due. Investors can assess the risk of the bonds by referring to the credit ratings given by local and international credit rating agencies to the bond issuers.

ii. **Relationship between Interest Rates and Maturity**
The risk associated with a bond increases with the length of maturity. To compensate for this increased risk, investors demand a higher rate of interest for bonds that take a long time to mature.

iii. **Relationship between the Price and Yield of Bonds**
The price of fixed rate bonds fluctuates according to changes in market interest rates. Prices for fixed rate bonds move inversely with changes in interest rates. In general, market interest rate movements have a larger impact on the price of bonds with a longer remaining period to maturity.

iv. **Liquidity of Bonds**
Liquidity of some bonds in the secondary market may be low. Investors may find it hard to buy or sell such bonds and need to hold them to maturity.

v. **Terms of Bond Issues**
It is important that investors pay attention to the terms of issue. For example, they should find out if the bonds may be redeemed before maturity.

vi. **Overall Market Conditions**
As with all investments, returns on bonds are influenced by external factors such as interest rate movements, inflation, exchange rates and political changes.

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