



## *The search for high investment returns...*

The current low interest rate environment facing local and regional investors have left individuals with a sense of bewilderment. The question asked by most investors is “Where can I invest my funds to earn the returns of the recent past?” Investing in bonds may be an avenue to which investors can turn. This article is aimed at individual investors who share this belief, but are uncertain as to what factors to consider when investing in bonds. With the use of table 1, I will attempt to explain some general concepts which I hope will prove useful in your ‘bond investing’ decisions.

**Table 1: Emerging Market Bonds Comparison**

Bond Issuer	Maturity Date	Credit Rating (S&P)	Coupon	Offer Yield to Maturity	Bid Price	Offer Price
Venezuela	1-Dec-2018	BB-	7.000%	13.15%	\$67.50	\$68.50
Brazil	14-Oct-2019	BBB-	8.875%	5.04%	\$127.00	\$129.00
Philippines	17-Jun-2019	BB-	8.375%	5.64%	\$118.50	\$119.63

Source: Bloomberg

### **Required Return**

The first step in the investment process is for you, the investor, to determine your required return. This required return should represent the minimum rate of return which you require as compensation for investing your capital; it is also a reflection of your appetite for risk. In determining your required return, you must be realistic, and your decision should factor in the following:

- Current and anticipated economic and interest rates environment.
- The higher the required return the greater the risk that must be incurred.

The next step is to match your required return to the yield to maturity (YTM) of a bond or basket of bonds. The YTM is the yield/return that you would realize on a bond/s if the bond/s was/ were held until the maturity date. YTM is market-determined; it changes over the life of the bond (moves inversely to price) as investor’s perception of the riskiness of the bond changes. For example if your return requirement ranges from 5% to 6%, then from the above table either Brazil 2019 or Philippines 2019 may be suitable but not Venezuela 2018. Although the Venezuela 2018 has a much higher YTM of 13.15% (remember the higher the return the greater the inferred risk), the risk of investing in this bond surpasses your risk appetite.

## **Coupon**

The coupon is akin to the interest that you would earn over the life of the investment. For example, suppose you invest US\$1M worth of Venezuela 2018 bond which pays an annual coupon of 7%, your cash flow per year will be:  $7\% \times \text{US\$1M} = \text{US\$70,000}$ .

Unlike the YTM, the coupon in most cases remains static, so for investors looking for a steady cash flow, the focus should be on the coupon rate of the security/ securities.

Now, a possible confusing issue is the relationship between the coupon rate and the YTM. For example, why would an investor of Brazil 2019 bond receive a coupon of 8.875% but only realize a YTM of 5.04%?

The total return of a bond is divided into (omitting reinvestment income for simplicity):

- Coupon Income
- Capital Gains (difference between the price you purchase the bond and the price at which you redeem/sell the bond).

In the case of Brazil 2019 bond, if you purchased the bond today and held until maturity you would:

- Receive a coupon of 8.875% per year until maturity on amount of bonds invested.
- Pay today \$129 per \$100 (par) worth of bonds. At maturity the government of Brazil would redeem the bonds at par. This means you would incur a "capital loss" of \$29.

As such your realized return (YTM) on your investment must be less than your coupon rate, in this case.

Generally:

Bond trading at a premium (above par)  $\rightarrow \text{YTM} < \text{Coupon}$

Bond trading at par  $\rightarrow \text{YTM} = \text{Coupon}$

Bond trading at a discount (below par)  $\rightarrow \text{YTM} > \text{Coupon}$

## **Liquidity**

It may become necessary prior to maturity, for the investor to sell some or all of their holding in the bond because of their desire for cash, to crystallize capital gains or prevent further capital loss. As the issuer of the bond generally only redeems the bonds at maturity, you would be dependent on other market participants' willingness to purchase the bond from you.

Liquidity most commonly refers to the ease with which a bond can be converted into cash, in a short period of time, without a significant decrease in its price or value.

Some factors that may affect liquidity are:

- Issue Size – The greater the number of individual investors in a bond, the greater the likelihood that an investor wanting to sell will find a counterparty to facilitate the transaction at a "fair" price, and vice versa. As such the larger the
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issue size, the less likely one investor or small group of investors will have ownership over majority of the issued bonds, thus higher the liquidity. Generally, the Eurobond market benchmark issues have a minimum issue size of US\$500M.

- Market Depth – Refers to the size of an order needed to move the market a given amount. If the market is deep, a large order is needed to change the price.
- Bid/Ask Spread – The larger the difference (spread) between the offer and bid price, the lower the liquidity of the bond.
- Market Resilience - In a resilient market, a security will rebound quickly from sudden price changes. Temporary price changes resulting from order imbalances tend to attract offsetting orders relatively quickly.

### **Credit Rating**

Credit risk or default risk is the risk undertaken by the lender that the borrower will default either on interest payments or on the repayment of principal on the due date, or both. Firms and sovereigns wishing to borrow internationally (and in some cases domestically) are usually required to have their creditworthiness determined by an independent third party.

These independent third parties are called credit rating agencies. The largest rating agencies are S&P (Standard and Poors), Moody's and Fitch. These rating agencies assign a credit rating to the firm or bond issued by the firm, which can be used to assess the probability of default by a firm and thus reflects the expected loss from investing in a bond issue. 'BBB' rating and above is referred to as investment grade, whilst below 'BBB' is referred to as speculative or junk category.

### **Interest Rate Risk & Tenor**

Interest rate risk is a key risk for bond investors. There is an inverse relationship between interest rates and bond prices; as interest rates rises, bond prices fall and vice versa. Bond investors need to be mindful of the current interest rate environment/cycle as well as anticipated changes in the interest rate environment/cycle. Further, the longer the tenor of the bond the greater the impact of changes in interest rate on the price of the bond (positive or negative); this is known as duration.

### **Conclusion**

In collaboration with the above information, one of the most important criteria is for you, the investor, to perform your own research prior to investing and draw your own conclusions.

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## FINANCIAL & ECONOMIC INDICATORS

As at 18 February, 2010

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	91.81	89.77
Euro	1.35	1.37
Jamaica	89.72	89.85
Guyana	204.70	204.90

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	79.06	75.28
Natural Gas (US\$/mmbtu)	5.39	5.50
Gold (US\$/Troy Ounce)	1,108.70	1,095.40

### Eurobond Indices (As at 18-02-10)

Lehman Brothers Global Aggregate Index (Return % YTD as at 10 Feb 10)	-0.08
JP Morgan EMBI+ (Basis points)	292
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	1.60

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.13	0.13
Euro Zone	1.00	1.00
Japan	0.10	0.12
Brazil	8.75	8.75
Trinidad	5.00	5.00
Jamaica	10.00	10.00
Barbados	2.50	2.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.11	0.11
US 10-Yr Treasury	3.80	3.72
3-month UK Libor	0.64	0.63
Japan 90-day T-Bill	0.28	NA
Brazil 90-day T-Bill	8.85	8.80
TT 90-day T-Bill	1.29	1.29
Jamaica 90-day T-Bill	11.35	11.35
Barbados 90-day T-Bill	3.33	3.33

Sources: Bloomberg, J.P. Morgan, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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