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Your Global Investment Authority

Investment Basics: Bonds

The bond market is by far the largest securities market in the world, providing investors with virtually limitless investment options. Many investors are familiar with aspects of the market, but as the number of new products grows, even a bond expert is challenged to keep pace. Once viewed as a means of earning interest while preserving capital, bonds have evolved into a $100 trillion global marketplace that can offer many potential benefits to investment portfolios, including attractive returns.

Before tackling the complexities of this huge and diverse market, it is important to understand the basics: What is a bond and how can bonds help meet your investment goals?

What is a bond?

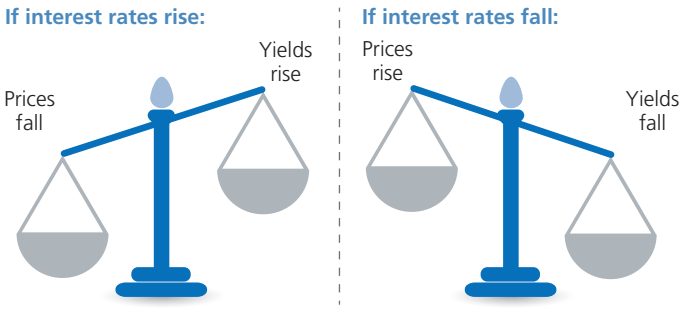
A bond is a loan that the bond purchaser, or bondholder, makes to the bond issuer. Governments, corporations and state governments issue bonds when they need capital. An investor who buys a government bond is lending the government money. If an investor buys a corporate bond, the investor is lending the corporation money. Like a loan, a bond pays interest periodically and repays the principal at a stated time, known as maturity.

Suppose a corporation wants to build a new manufacturing plant for $1 million and decides to issue a bond offering to help pay for the plant. The corporation might decide to sell 1,000 bonds to investors for $1,000 each. In this case, the "face value" of each bond is $1,000. The corporation – now referred to as the bond issuer – determines an annual interest rate, known as the coupon, and a timeframe within which it will repay the principal, or the $1 million. To set the coupon, the issuer takes into account the prevailing interest-rate environment to ensure that the coupon is competitive with those on comparable bonds and attractive to investors. The issuer may decide to sell five-year bonds with an annual coupon of 5%. At the end of five years, the bond reaches maturity and the corporation repays the $1,000 face value to each bondholder.

Every bond also carries some risk that the issuer will "default," or fail to fully repay the loan. Independent credit rating services assess the default risk, or credit risk, of bond issuers and publish credit ratings that not only help investors evaluate risk but also help determine the interest rates on individual bonds. An issuer with a high credit rating will pay a lower interest rate than one with a low credit rating. Again, investors who purchase bonds with low credit ratings can potentially earn higher returns, but they must bear the additional risk of default by the bond issuer.

What determines the price of a bond in the open market?

Bonds can be bought and sold in the "secondary market" after they are issued. While some bonds are traded publicly through exchanges, most trade over the counter between large broker-dealers acting on their clients' or their own behalf.



A bond's price and yield determine its value in the secondary market. Obviously, a bond must have a price at which it can be bought and sold, and a bond's yield is the actual annual return an investor can expect if the bond is held to maturity. Yield is therefore based on the purchase price of the bond as well as the coupon.

A bond's price always moves in the opposite direction of its yield, as illustrated above. The key to understanding this critical feature of the bond market is to recognise that a bond's price reflects the value of the income that it

provides through its regular coupon interest payments. When prevailing interest rates fall – notably rates on government bonds – older bonds of all types become more valuable because they were sold in a higher interest-rate environment and therefore have higher coupons. Investors holding older bonds can charge a "premium" to sell them in the secondary market. On the other hand, if interest rates rise, older bonds may become less valuable because their coupons are relatively low, and older bonds therefore trade at a "discount."

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Sydney
PIMCO Australia Pty Ltd
ABN 54 084 280 508
AFS Licence 246862
Level 19, 363 George Street
Sydney, NSW 2000
Australia
612 9279 1771

Amsterdam

Hong Kong

London

Milan

Munich

Newport Beach Headquarters

New York

Rio de Janeiro

Singapore

Tokyo

Toronto

Zurich

australia.pimco.com

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