Bonds and the global financial markets

Fact sheet

Bonds are generally considered to be a defensive asset, offering lower risk compared to growth assets like shares. Returns tend to be lower and may not outpace inflation in the long term.

What are bonds?

A bond is essentially a loan. When an investor buys a bond, they are effectively lending money to the issuer of the bond. The issuers of bonds include the Australian federal and state governments, foreign governments and Australian and international companies.

Bonds have three major components: face value, coupon rate and maturity date.

- The **face value** (also called the 'principal') is the amount the issuer of the bond receives when it is issued. It is also the same amount repaid to the bond owner at the maturity date unless the bond issuer defaults or fails to meet their financial obligations under the bond.
- The **coupon rate** is the annual rate of interest payable on the face value of the bond when it is issued. The higher the coupon rate, the higher the interest payments the bond owner receives over the life of the bond. Typically, bonds make interest payments half-yearly.
- Bonds have a stated **maturity date**. Generally, this is the date bond issuers repay the money that bond owners loaned them. Bonds could have a maturity date that is over a year and up to ten years or more.

How do interest rates affect bonds?

Over the life of a bond its market value or price will go up and down. One of the key drivers of the price of bonds is changes in interest rates. The price of a bond rises when interest rates fall. Conversely, the price of a bond falls when interest rates rise. Expectations of changes in interest rates can also affect the price of a bond before interest rates actually change, as investors anticipate the change.

For example, let's say you buy a 10-year bond when the market interest rate is 3%. If market interest rates then rise or are expected to rise to 6% soon after and you want to sell that bond, the person buying it will not want to pay for an asset only paying an income of 3% when they can expect to earn 6% in the market. Therefore, you would have to sell the bond at a price that will be below what you originally paid – resulting in a capital loss.

What other factors affect the value of bonds?

The market value of bonds can also be affected by the credit quality of the bond issuer (the borrower), inflation expectations and the length of time to maturity. As inflation expectations increase or credit quality of the issuer decreases, the price of the bond decreases, reflected as a higher market interest rate for the bond. The price of bonds with longer maturity dates are typically more affected by these factors compared to bonds with shorter maturity dates.

Rest is required to price its portfolio of bonds on a regular basis to take account of the changes in the market value of bonds, which could rise and fall.

If there's anything we can do

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