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focus



How rising interest rates **impact your bond portfolio**

Typically investors think about bonds as being the stable safe part of their portfolio. Over the past 18 months or so this hasn't been the case and bond prices have seen some of their sharpest falls in history. This is a good news and bad news story. While the market value of bonds has fallen, for investors who plan to own them to maturity these "losses" on bonds aren't permanent – they will still receive the same interest on their investment and be repaid in full when the bonds mature. Furthermore, those investors reinvesting their money today will receive a higher return going forward.

...Until recently interest rates have been on a slow and steady decline for 20 years or so...



Why do bond prices rise and fall?

A number of things can influence bond prices – interest rates, credit spreads and credit ratings. The sharp moves in interest rates have been the chief driver in recent time.

Interest rates – rising off the floor

Although interest rates move higher and lower on a daily basis, the recent moves may be unfamiliar to many. Until recently interest rates had been on a slow and steady decline for 20 years or so. During the peak of the global pandemic the New Zealand three year swap rate (a wholesale interest rate against which bonds and mortgages are priced) reached a low of -0.035% (yes, negative!). It is little surprise then that interest rates rose as the world emerged from COVID. What has surprised is the pace of that rise.

THREE YEAR SWAP RATE



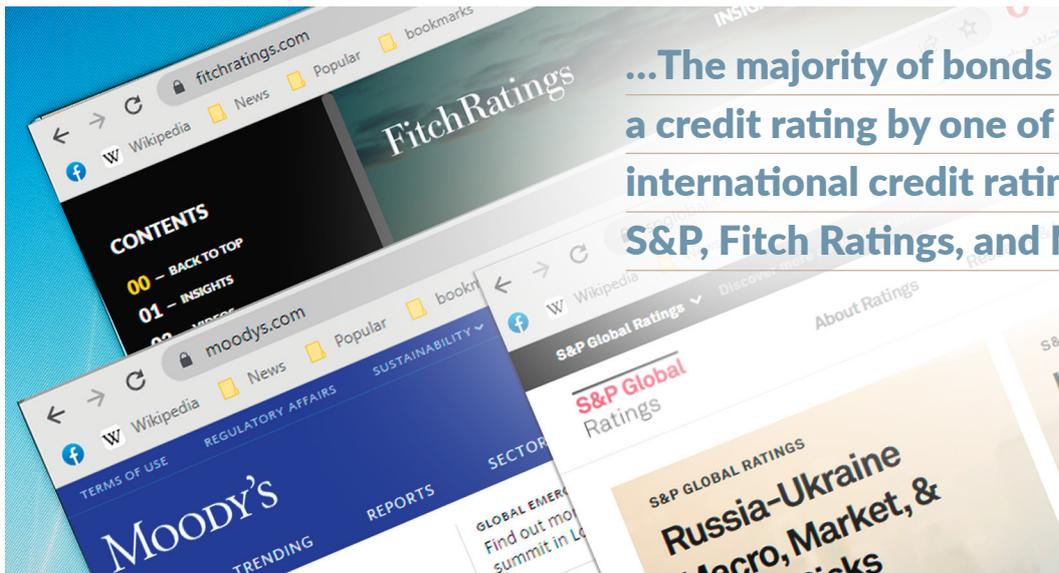
Source: Refinitiv, Forsyth Barr analysis

Bond prices move in the opposite direction to interest rates – when rates rise, bond prices fall (and vice versa). A measure of how sensitive the price of a bond security or portfolio is to the change in interest rate is called duration.

Duration is measured in years. Typically the higher the duration of a bond (or the longer you'll have to wait to receive the interest and principal repayment) the more sensitive it is to interest rates.

As a general rule, for every 1% increase or decrease in interest rates, a bond's price will change by approximately 1% in the opposite direction for every year of duration. For example, for a portfolio or bond with a duration of 3.3 years a 100bp (1.00%) change in interest rates would impact the market value by approximately 3.3%. The reason for the change is investors buying today now demand a higher return on that bond, made up of both the interest payments and future changes in capital value.

Understanding duration as a measure of a portfolio's sensitivity to interest rates is particularly important for those planning on selling bonds prior to maturity. If interest rates are expected to rise a shorter duration is preferred. Conversely, if interest rates are expected to fall these investors would prefer longer duration bonds.



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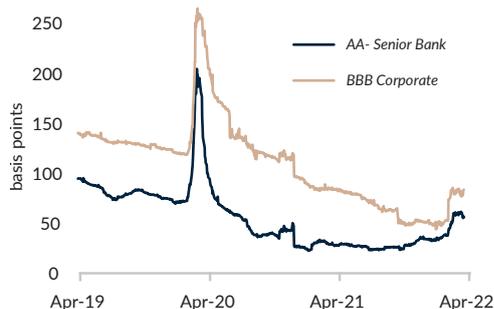
Credit spreads – a premium for risk

The yield on any fixed income security is made up of two components: (1) the underlying interest rate e.g. the swap rate or Government bond rate, and (2) the credit spread, or a margin reflecting the credit risk of the borrower. For example, if the five-year government bond rate was 3% and a comparable length bond for Company X paid 4%, the credit spread is 1% (or 100 basis points).

The riskier the borrower (the issuer of the bonds) the larger the credit spread. Credit spreads can move due to changes in economic conditions, particularly during a financial crisis, or specific events related to an issuer.

Anything that increases or lowers the risk that a borrower might not repay its debts will impact the credit spread. For example, during the early stages of COVID credit spreads for many industries and companies expanded dramatically due to huge uncertainty around the outlook for the global economy. As it became apparent actions from central banks and governments would prevent another Great Depression, credit spreads fell sharply.

NEW ZEALAND CREDIT SPREADS



Credit ratings

Related to credit spreads are credit ratings. The majority of bonds are assigned a credit rating by one of three international credit rating agencies – S&P, Fitch Ratings, and Moody’s. Ratings are simple to understand – they’re on a sliding scale with AAA considered the highest quality (i.e. the least risky, mostly government bonds) all the way down to D (as in default). Higher rated bonds typically pay a lesser credit spread relative to lower rated bonds.

Many factors are considered when assigning a credit rating such as an issuer’s industry risk, country risk, its competitive positioning, and of course its financial metrics.

The investment industry deems any bond with a credit rating above BBB- to be “investment grade”. Those with ratings below BBB- are known as “high-yield bonds” or (less charitably) “junk bonds”.

High-yield bonds are judged to be of greater risk of not being repaid in full. Issuers of high-yield debt can include early-stage companies that don’t earn a profit, companies with high debt levels, or “fallen angels” – issuers whose financial positions have deteriorated and have been downgraded from investment grade.

Credit ratings provide a helpful starting point when assessing prospective bond investments but we’d warn against relying on them alone. Russia is a recent example of how the outlook can change quickly. In late February S&P reaffirmed its BBB- investment grade rating. Five days later this was cut five notches to CCC-, and today it sits at CC, one notch above C which is for borrowers who have filed for bankruptcy.

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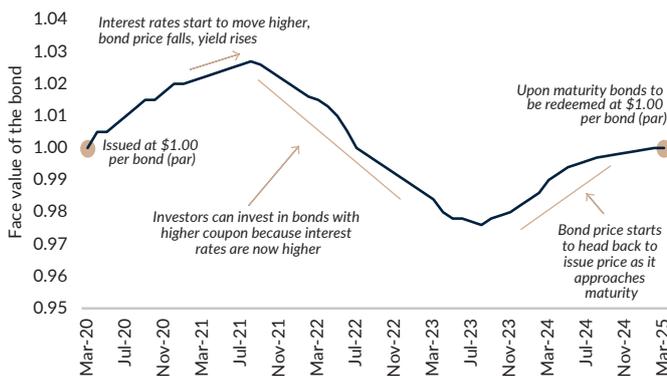


Not all bad

Bonds are different to shares. They typically provide stable cash flows and a high degree of capital protection. The recent bond price volatility is rare and eventually will pass leaving a higher interest rate environment.

It's important to remember, firstly, that means investors will get a higher return on any new bonds purchased. And secondly, the bond "losses" experienced in recent times aren't permanent. For investors planning on holding a bond to maturity the price returns back to par (the issue price) as it approaches maturity (unless, of course, the borrower defaults, generally not a common event). For example, a bond issued at the par price of \$1.00 and held to maturity will be redeemed at that \$1.00 par value regardless of any interest rate moves over the life of the bond.

THE LIFE OF A BOND



Source: Forsyth Barr analysis



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Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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