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Savings bonds
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Corporate bonds
How can they fit into your investment plans?

A low risk option
A safer investment in a tough climate

MEDIA PLANET

No. 1 / May '12

INVEST IN BONDS

WHY NOW IS THE TIME TO INVEST

Since the London Stock Exchange launched the Order Book for Retail Bonds in 2010, the market has seen huge growth and is set for continued success in 2012

PHOTO: SHUTTERSTOCK

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CHALLENGES

Bonds are a much safer investment than equities, but many investors know relatively little about them. Read this guide to see how bonds can fit into your investment portfolio.

Benefit from buying into bonds

These are tough times for savers and investors alike. Rock bottom interest rates mean that savers are getting nothing like the returns they could expect just five years ago, while the ongoing turmoil in the economic markets and especially the unwelcome news that Britain has just entered a double dip recession mean that many people are very wary of investing in equities. It sometimes seems that those who wish to build up any form of personal wealth are caught between a rock and a hard place.

For savers and investors

However, there is an alternative and it is becoming increasingly popular: the bond market. Both savers and investors can be accommodated in the bond market, savers through savings bonds, and investors through corporate bonds. These do not have quite the same level of very low risk that savings bonds have, but they are much safer than equities, while providing a return that is often a good 10 times higher than the base rate. And then, of course, there are gilts, rock solid government bonds that have been popular with investors for decades.

Know your bonds

There is still a degree of ignorance surrounding the bond market, and so in this supplement, we aim to explain the difference between savings and corporate bonds and how to go about investing in each. We will also explain how you can hold bonds in ISAs and what the current limits are, what kind of return you can expect and why bonds are an excellent destination in a low interest environment. In essence, corporate bonds and loan notes can offer the private investor a short term, high yield in a time of low interest rates, plus the additional opportunity for capital growth.

Here to stay

Even when the economy does start to recover and interest rates start to rise again, investment in the bond market by private investors is clearly here to stay. It has always been crucial to diversify a portfolio between different asset types such as cash, equity and property and bonds can now be added to that list. And as the population grows older and pension provision becomes ever more imperative, bonds are a good way of building up not only some capital but of guaranteeing an income in later life.

Constant developments

The area continues to see innovations, too. Just over two years ago, the London Stock Exchange launched the Order Book for Retail Bonds (ORB) to enable private investors to be able to trade in them directly, rather than through bond funds, and most stockbrokers now offer bond trading services just as they always have done with equities.

The face of bonds keeps changing.

Last year John Lewis launched a highly innovative product, a five-year Partnership Bond, a bond with a 6.5 per cent yield, made up of a 4.5 per cent annual cash return plus an extra two per cent in the form of John Lewis partnership vouchers. This is not a typical corporate bond, and cannot be traded or cashed in early, but it is a sign that the market continues to develop. Read on and discover how you can benefit from the world of bonds.

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WE RECOMMEND

Simon Lambert
Assistant Editor,
This is Money.co.uk

PAGE 6

'You can buy through a broker directly from the company or you can use a wealth management expert and invest through a bond fund. These invest in a number of different bonds, and so spread the risk'

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INVEST IN BONDS, 1ST EDITION, MAY 2012

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INSPIRATION

Question: How has the bonds world changed in recent years?

Answer: In 2010 the London Stock Exchange launched the Order Book for Retail Bonds and since then there has been many changes.

INNOVATIONS

Until just over two years ago, the only way for private investors to invest in bonds was through bond funds. However, as interest rates remained at historically low levels and equity markets careered wildly in response to the difficult economic climate, bonds became increasingly popular, and so in February 2010 the London Stock Exchange launched the Order Book for Retail Bonds (ORB), which allows private investors to trade directly in bonds through their broker, just as they do in stocks and shares.

It is "an electronic trading platform offering investors a cost effective, transparent and efficient mechanism for concentrating on screen liquidity and facilitating price discovery in a range of corporate bonds and gilts," according to the Exchange.

Success story

The ORB has been extremely successful. Since trading began in 2010, the total capital raised has been £1,637,700,000, over £230 million in 2010, over £1,247 million in 2011 and £160 million in the year so far.

The first issuer to launch a bond on the new exchange was the Royal Bank of Scotland, with a £50 million 10-year offering with a coupon on 5.1 per cent; this was followed by Provident Financial, paying a generous seven per cent on its 10-year offering which raised just over £25 million. In April this year, Provident launched a five year bond paying out the same amount, although this time the issue was much larger, at £120 million.

Going further afield

Innovations are taking place all the time. The ORB has now launched a dedicated segment for international bond issues, and in May HSBC launched a Renminbi-denominated bond raising RMB 2 billion (£196 million), the first non-sterling denominated bond on the exchange. Nor is it just companies that are able to raise money in this way. In January this year, Places for People, one of the UK's largest social housing groups launched a 10-year bond to raise £40 million. The coupon is variable: one per cent, which will be adjusted to take into account the rate of inflation, and it is tradable in denominations of £100, rather smaller than the usual, which tends to be £1,000 minimum. It takes the amount the organisation has earned on ORB to £180 million.

Growing demand

"We are delighted that Places for People have decided to return to the retail bond market within a year of their first issue," said Pietro Poletto, head of Fixed Income Markets at the London Stock Exchange. "The successful placing of their second retail bond reflects positively on the development of the market and highlights the growing demand from investors. The placing also demonstrates the effectiveness of the market for companies seeking alternative sources of funding providing flexibility for both large and smaller issuers."

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PHOTO: SHUTTERSTOCK

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INSPIRATION

Question: Is there a totally safe way of obtaining a slightly higher rate of return on savings?
Answer: Yes, through a savings bond, although the money will have to be tied up for a set period and the minimum amount is usually £1,000.

When cash really is king

CHANGE

In this climate of low interest rates and very uncertain stock markets, finding a safe and slightly higher than average return on your money can be extremely difficult. One of the best options is a savings bond, which differs slightly from a savings account, in that money is tied up for a fixed period to obtain the full rate of interest, and there is normally a minimal sum that you must invest. But the bond is still protected by the Financial Services Compensation Scheme £85,000 individual savings protection cover. This in effect means that your capital is totally safe up to the £85,000 limit, on top of which you will be receiving a guaranteed return.

Pros and cons

"The advantage of a savings bond is that you will be receiving a specific return over the lifetime of the bond. The longer your money is tied in, the more likely you are to receive a better rate," says Rachel Springall of financial information service Moneyfacts.co.uk. "You will almost certainly get a better rate than you would have done from a no-notice savings account. They are much safer than equities, although the return is not so great."

Shop around

Savings bonds are issued by banks and building societies, with the lesser known names offering the highest rates, so savers should shop around before deciding where to tie up their cash. Unlike with investment bonds, in which the lesser known names might be considered as "junk" status and thus not so safe to invest with, even savings bonds from the most obscure names are still totally safe, due to that all important Financial Services Compensation Scheme guarantee (as long, of course, as the institution that has issued the bond is covered by the scheme.)

'The longer your money is tied in, the more likely you are to receive a better rate'

Rachel Springall, Moneyfacts.co.uk

The amount you will receive in interest is determined by a number of factors, including the base rate, inflation climate and the amount of time over which you can tie up your cash. These returns have changed considerably over the last few years. According to Moneyfacts.co.uk, in January 2008, the average return on a one year bond was six per cent, whereas now it is 2.68 per cent. Paradoxically, back then, it was the longer term bonds that yielded a lower return: the average five year rate was 5.08 per cent, whereas now it is 3.99 per cent, a consequence of underlying very low base rates.

Getting the best return

Now, the longer you can tie your money up, the better the return will be, and with current high inflation rates, this is the only way you can hope to start to get a better return on your savings (although of course, if inflation rises, the savings rate you have tied into will not). The advantage of this is complete certainty as to what your return will be and even if base rates do start to rise midway through your savings scheme, you can always come out of the old saving rate and lock into a new one. These products are particularly suitable for people who need some certainty of income, such as pensioners, and they are also a good way of starting to build up a savings base for a child.

Know your options

As with many savings products, the more you save, the better your return is likely to be. Most of the products that pay the highest rates require a minimum investment of at least £1,000 and in some cases £2,000. However, there are some savings bonds that will allow you to out aside as little as £1. As ever, it pays to shop around.

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PUT IT AWAY
The more you save, the better your return is likely to be
PHOTO: SHUTTERSTOCK

MAXIMISING RETURN

PHOTO: SHUTTERSTOCK

Tax free allowance

The best way to maximise the return you make on a savings bond is to put it within the wrapper of an ISA. "You have the tax free element: savers don't need to take into account their own tax rates," says Rachel Springall of Moneyfacts.co.uk. Savings bonds count towards the cash element you can save in an ISA: in the current tax year, 2012/13, you can put up to £5,640 away.

PHOTO: SHUTTERSTOCK

Search for the best rates

Again, returns have dropped quite dramatically over the last few years, mirroring the very low base rate: in January 2007, the average rate of return on an ISA was 4.81 per cent, according to Moneyfacts.co.uk and now it is 2.68 per cent. However, if you shop around it is possible to get a much better return than that.

PHOTO: SHUTTERSTOCK

Deals for all

As ever, the more you can put away the better the return you will get, with £2,500 being typically the amount needed to tie into the best rates. However, there are also deals available for savers with as little as £1. And again, it is worth seeking out the more obscure names, as they often offer the best returns.

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NEWS

RETURN ON INVESTMENT
Simon Lambert describes a corporate bond as an IOU from a company. Find out if this could be the right investment option for you
PHOTO: SHUTTERSTOCK

High return with low risk

Question: How is it possible to make a higher return than savings can offer without being exposed to the risk of the stock market?

Answer: By investing in corporate bonds, which can offer yields 10 times higher than the bank rate.

SHOWCASE

Another way for investors to get a higher return than they could do on a normal savings account, without the risk attached to equities, is by investing in a corporate bond. "A corporate bond is essentially an IOU from a company," says Simon Lambert, Assistant Editor of This Is Money.co.uk. "You lend them a certain amount of money over a set time, usually five or 10 years, and they pay you a set level of interest, known as a coupon, and then pay you the whole of the money back at the end of the term." In other words, you can buy, say, a £10,000 10-year bond with a five per cent coupon, which means you will get £500 a year in interest for 10 years and then the whole of the £10,000 back at the end of the period.

Know the risks

This is an investment and not a savings product, so it is not covered by the Financial Services Compensation Scheme. Corporate bonds are considered to be safer than equities, because if the worst happens and the company collapses, the bond is considered to be a higher order of debt than equity and so bond holders will be paid before shareholders get anything. But there are also "junk bonds" which are much higher risk than those issued by household names, and if the underlying company collapses you may not get anything.

However, even if a company remains healthy and intact, bonds are still the safer bet: "The share price might fall and the dividend may be cut back, which means shareholders could lose some of their capital outlay and see a lower rate of return," says Lambert. With bonds, as long as the underlying company is healthy, you will lose neither capital nor income. It should be noted that the potential upside for equities is bigger, as well.

> 'A corporate bond is essentially an IOU from a company'
>
> **Simon Lambert**
> Assistant Editor, This is Money.co.uk

Trading bonds

These bonds can also be traded, which means you can get out of them at any time, and this can also affect the return you will make. When bonds are issued their face value is known as "par." But they are traded on the secondary market and their price will rise and fall depending on what is happening to interest rates: if a bond pays out a high interest rate and base rates are very low, its price will rise and it will be trading "above par." If it has a low interest rate and base rates rise, then it will trade at "below par." That means that when bonds are trading, they are also quoted with a "yield to maturity," which means the overall return you will get when both the coupon and the changes in price are taken into account.

Capital gains

"If you buy the bond at a discount on the secondary market, then your yield to maturity will be higher than the original coupon rate, and if you buy it above par, your yield to maturity will be lower," says Lambert. It also means that if you buy a bond trading at below par and the interest rate climate changes, then the price may rise, leading to the potential of capital gains, on top of the annual interest payments.

BENEFITS

- Another of the **benefits** of investing in corporate bonds is that you are allowed to hold them in ISAs, as long as they have at least five years to maturity when you put them in and they are officially listed on a recognised stock exchange anywhere in the world.
- The **limit** is £11,280 in a stocks and shares ISA. That way, the income you earn along with any capital gain will all be **tax free**. This will make the charges slightly different: for example, a stock broker might charge one per cent for a bond deal outside an ISA and 1.65 per cent if it's in an ISA.
- There is also **no stamp duty** to pay on bonds, whereas on shares it's 0.5 per cent.

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QUESTION & ANSWER

Simon Lambert
Assistant Editor, This is Money.co.uk

How do I go about investing in bonds?

! There are two ways. You can buy through a broker directly from the company or you can use a wealth management expert and invest through a bond fund. These invest in a number of different bonds, and so spread the risk — in fact, in many cases, bond funds are actually the safest way of investing in bonds.

Will I have to pay a management fee?

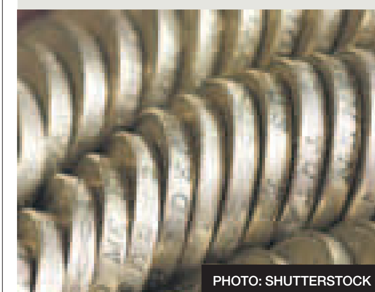
! Yes, but you are paying not just to spread the risk but to access the fund manager's expertise. This will appear in two ways. First, the fund manager will be able to assess the relative risk of a bond and secondly he or she will be playing the swings in the market. This means the return you get will be not just the coupon, but any capital gains the fund manager manages to make.

Will I get all my capital back?

! If the fund performs well, you could get more than the original capital. However, if it performs badly, you may not. That is another difference between investing directly into a bond and via a bond fund: if you are holding the bond directly, then as long as the company doesn't go bust, you will receive its face value at maturity. Of course, you might not have paid its face value — you might have paid at above or under par. They key is to remember that the price of bonds and bond funds tend to move in the opposite direction from interest rates.

Are bond funds fixed interest investments?

! No, they're not as the rise and fall in the price will affect the return they provide to the investor. But no corporate bond is a fixed interest investment in the way that a savings bond is for the same reason — the changing price.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