Part 3 – The Benefits of Investing in Bonds

In capital markets, the stock market is probably the most popular and the most understood. However, given the size of the bond market globally it could be argued that it is probably the most important as it provides a base for the other segments of the capital market and for the economy at large. Certainly, more money is raised by Corporates and Governments to fund investment from the bond market than from the stock market.

From the issuer's perspective, raising capital by issuing bonds has two (2) major benefits. Firstly, bonds enable Corporates and Governments to borrow money relatively cheaply as the money is borrowed directly from investors and not through a financial intermediary. Further, owing to the lower cost of funds and the medium to long term nature of bonds, the burden associated with raising bond capital is relatively low.

Secondly, bond issuances do not dilute the shareholding in the issuer. As such, bonds have the potential to enable the company to increase potential earnings without increasing the shareholder capital. That is, a company can choose to raise capital through a bond issuance and utilise the proceeds to undertake a big project which could in turn generate greater earnings and magnify shareholders' returns with the limited shareholders' equity. This is called leveraging. In this instance, the issuer benefits from with enriched returns and the bondholder continues to be paid interest accordingly.

How do bonds differ from shares from an investor point of view? A bond makes its holder a creditor of the issuer (Corporate or Government) and has no ownership interest in the company or entity. On the other hand a shareholder is a part-owner of a company. Further, shareholders have voting rights and they can express their rights during the issuer's Annual General Meetings (AGMs) while bondholders do not. Adding to the abovementioned, because bondholders are creditors of the issuer, they have a senior claim against the issuer's assets during liquidation than the owners of the company. When companies are wound down the first people to be compensated are the creditors such as bondholders and if there is anything left it is in then distributed to the shareholders in proportion to their stake in the company.

When investing, investors primarily consider two (2) keys objectives which are the creation of extra income and the protection of their principal investment. Both bondholders and shareholders have an expectation of some cash flows from the issuer or company. The difference between the two cash flows is that the bondholder's cash flow tends to be less volatile than the one received by the shareholder. The bondholder receives regular pre-determined interest payments while the shareholder receives dividends as and when the company declares dividends and this depends on the company's financial performance at the time. It is because of the preceding that bonds are referred to as fixed-income securities because they offer a predictable and stable income return. In other words, the

payment of interest to bondholders by the issuer is not dependent on the issuer's profits. It is an expense that the issuer incurs and must pay just like it must pay rent, utilities and salaries.

Moreover, when we consider the protection of principal investment bonds are relatively secure as the issuer promises to pay back the bondholder's principal upon maturity of the bond. Inversely, the principal investment of the shareholders is not protected. The value of the shareholders principal invested is dependent on the market price of the company's shares and there is a chance that by the time the investor wishes to divest from shares the value of their holding may have grown significantly or may have grown adversely altogether. It is for these reasons that bonds are considered to be relatively safer investments than shares.

This article was written by BSE Product Development Manager, Mr Kopano Bolokwe, as a build up to the 2016 Botswana Bond Market Conference and was published during the week of 9 September 2016.