

## Fixed Interest – An Introduction

Fixed interest investments are loans made to governments or companies. These loans pay a fixed amount of interest for a fixed period of time, after which they are repaid (redeemed). The loans are issued as securities which can be bought and sold on a stock exchange and it is that which allows us to invest in them. The generic term for fixed interest securities is “bonds”.

When the bonds are issued by the British government, we refer to them as gilt edged securities (gilts) and when they are issued by companies, we refer to them as corporate bonds.

There are two main types of credit risk associated with bonds. These are the risk of default on the payment of interest and the risk of default on redemption. Government bonds issued by the main western economies are considered to have a negligible risk of default. Corporate bonds have a greater risk of default and this is one area where the opportunities and risks arise.

Up until the point at which they are redeemed, the price of a bond will fluctuate as a result of the changes in market interest rates. If interest rates rise, investors will demand to pay a lower price for a certain amount of income and so the price of the bond will fall. If interest rates fall, investors will be willing to pay a higher price for a certain amount of income so the price of the bond will rise. A professional manager of a fixed interest fund can benefit from falling interest rates and help to offset the effect of rising rates by careful selection of the bonds in his portfolio.

Corporate bonds require the additional and very important skill of credit analysis. Companies are rated by the credit agencies such as Standard & Poors and bonds issued by a company with a rating of AAA, AA, A & BBB are said to be “investment grade” whilst bonds issued by companies with a credit rating of BB or below or by a company with no rating are said to be either “non investment grade” or “high yield”. In the US they are sometimes called “junk bonds” but that is not a very good description.

The lower the rating, the greater the default risk if something goes wrong at the company and so the higher the interest rate that investors will expect to receive. Changes in a company’s rating can cause big movements in their price and so corporate bond fund managers never invest heavily in any one company and carry out detailed analysis to try to avoid losers. This is both a risk and a big opportunity and it is the skill of the manager to benefit from this.

Careful investment in fixed interest funds should be part of the asset allocation of any well constructed portfolio.