# Money Wise

Colin Bloodworth explains the government securities market

# Why Would Anyone Invest in Bonds?

The word "bond" has several meanings in the financial world. The bonds I would like to discuss today are securities issued by governments to support investment, spending or to repay existing debts.

Raising money this way avoids the pain of raising taxes. The bonds are generally for a fixed term and pay a guaranteed rate of interest. At the end of the term the capital is repaid in full.

**US Treasuries considered the safest**

US government bonds, or Treasuries, are considered among the safest investments in the world, despite being stripped recently of a AAA rating by Standard & Poor's. Both the Chinese and Japanese governments hold over $1 trillion of them. What kind of returns are they getting? Thirty-year bonds are currently paying 3.1 per cent per annum; 10-year bonds are yielding only 1.9 per cent.

Why is there such faith in US Treasuries? Basically, because default is unlikely. It is not impossible, however, and they could come to the brink of default in a few months unless politicians agree to raise the debt ceiling yet again.

But raise it they will, as a US default on its debt would destroy US Treasuries' reputation as a safe haven and would cause havoc in global financial markets. At the end of the day, any government can meet its debt obligations by simply printing money. The exception is the euro zone, where printing money is the prerogative of the European Central Bank. This is why individual countries have to offer rates of return that reflect their perceived ability to honor the debt.

**What about Indonesian bonds?**

Currently the return on Indonesian bonds is just over 5 per cent. In 2008 it reached an all-time high of 20.8 per cent at the height of the global financial crisis. Had you bought bonds then you would still be enjoying the high rate of interest that reflected the risk at that time.

At over 5 per cent, wouldn't it be better to buy Indonesian bonds as opposed to US bonds offering only 1.8 per cent? Well it could be, except that in 2012 the rupiah fell by 6 per cent against the dollar so you would have been worse off at the end of the year in US dollar terms despite the higher interest rate. On the other hand, had you bought US Treasuries the previous year you would have been worse off in rupiah terms, as not only was the rupiah offering a higher return, it also strengthened against the dollar. What will happen in 2013 is anybody's guess and this leads us to the other factors that must be considered when investing in bonds.

**What are the risks?**

Perhaps I should start by reiterating that there is risk in every investment. Even failing to invest is risky, since inflation will erode the purchasing value of cash over time.

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There are five main risks with government bonds: default, currency, political, inflation and interest rate.

Default risk is extremely small, although not impossible, where major countries are concerned. But defaults in emerging nations have occurred in the past and will no doubt occur again.

We have already seen how currency risk can affect the real return.

As for political risk, any government can manipulate the financial markets to its own benefit, although such interference will discredit the reputation of the country concerned and make it difficult to raise credit in the future.

Inflation is a big risk. Right now, the interest rates being offered by the US and several other "strong" economies are lower than their respective rates of inflation so the real return investors are getting from bonds is negative.

The final risk is that of interest rates. Should prevailing interest rates rise, the capital value of a bond will fall, meaning it is worth less on the market than you paid for it should you want to sell prior to its maturity.

**So why buy government bonds?**

The reason is very simple. By and large they are safe and guaranteed by the country of issue. They may not offer the same returns as stocks (the S&P 500 rose 13 per cent last year), but neither will they tumble like stocks as the S&P did by 37 per cent in 2008.

Pension funds, for example, cannot afford to risk everything in stocks to produce growth. Such strategies caused havoc with many funds in 2008. To ensure liquidity and guarantee their ability to pay pensions when due, they have to hold a large part of their funds in cash or government bonds. It is not their concern if the purchasing value falls.

For the same reason, the private investor should consider bonds as an integral part of a balanced portfolio, particularly when approaching retirement.

But we have considered only government bonds so far. There is a much wider universe of bonds to be explored.

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