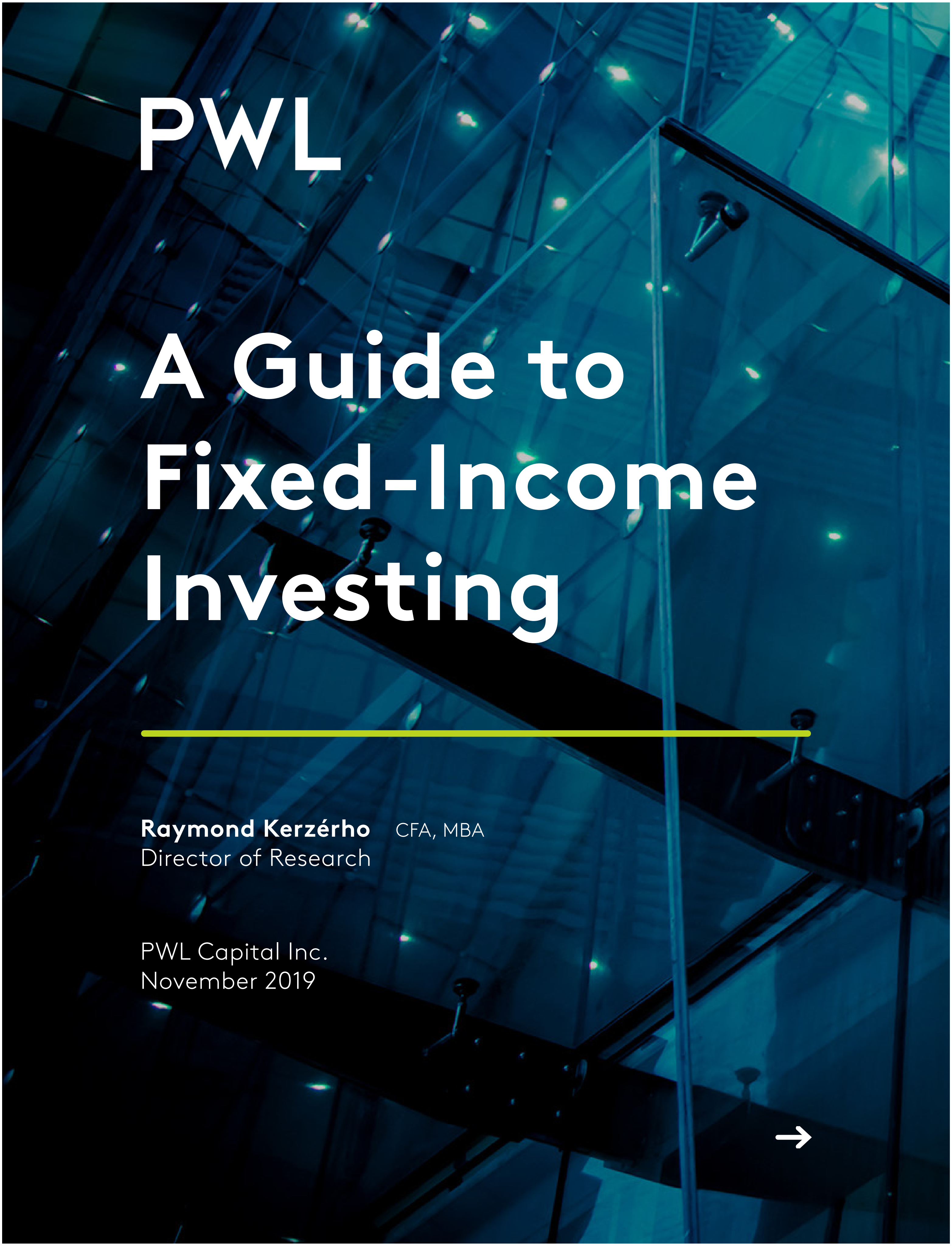


PWL

A Guide to Fixed-Income Investing

Raymond Kerzérho CFA, MBA
Director of Research

PWL Capital Inc.
November 2019

This report was written by Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the author and do not necessarily represent the views of PWL Capital Inc.

Raymond Kerzérho, *Director of Research*, PWL Capital Inc.,"A Guide to Fixed-Income Investing"

For more information about this or other publications from PWL Capital, contact:
PWL Capital – Montreal, 3400 de Maisonneuve Ouest, Suite 1501, Montreal, Quebec H3Z 3B8
Tel 514-875-7566 • 1-800-875-7566 Fax 514-875-9611
info@pwlcapital.com

1. The Basics

Bonds and other fixed-income securities do not receive much coverage in the media for a number of reasons. First off, bonds are a bit technical. While the drivers behind the ups and downs of a stock are easy to understand, those underlying bond returns are less straightforward. Secondly, everyone understands that with the current low interest rates available worldwide, future bond returns will likely be very modest, which isn't likely to make them a popular topic. And finally, there is far less publicly available information about bonds than stocks. Nonetheless, bonds and other fixed-income investments account for a major portion of most people's portfolios. This section aims to equip the reader with the basic tools to navigate the fundamentals of bond investing.

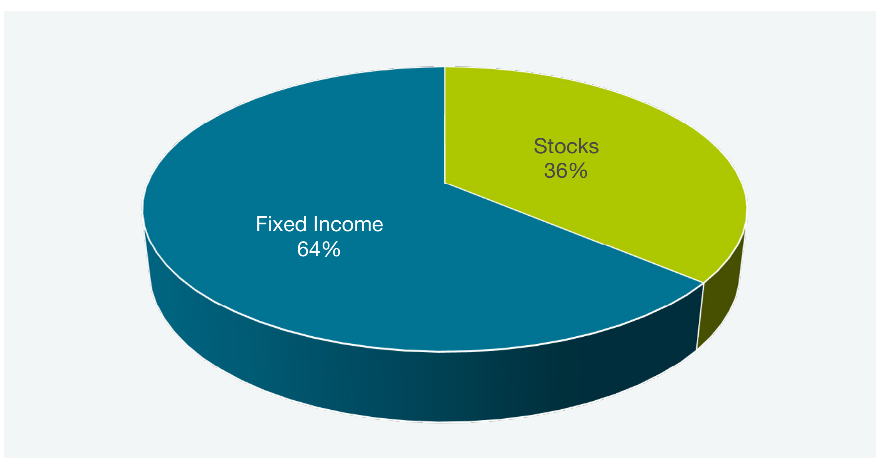
a. Bonds vs. Fixed-Income Securities

Bonds are interest-bearing securities with maturities extending beyond one year. Fixed-income securities include money market securities, which have maturities of one year or less, as well as bonds. For the sake of this article, we will use the terms "bonds" and "fixed-income securities" interchangeably, as bonds make up the bulk of the latter category.

b. Bonds are Big

The global fixed-income market accounts for 64% of all publicly traded securities ($102 trillion), compared to 36% for the global stock market ($58 trillion). In other words, the bond market is almost twice as big as the stock market.

Chart 1: The Global Public Market for Stocks and Bonds



Sources: Bank for International Settlements, Dimensional Fund Advisors

c. A Highly Fragmented Market

Unlike stocks, fixed-income transactions do not take place on a centralized market (an exchange). They mostly are realized through private transactions between securities dealers and investors. Furthermore, the variety of bond issues vastly surpasses that of equity securities. For example, the Royal Bank of Canada has only one common stock outstanding, but it has over 350 different bond issues.

d. Bonds vs. Stocks

A bond is a contract with a fixed payment schedule. Hence, a bond holder is able to estimate its future return if held to maturity. By contrast, a stock is a residual claim on whatever is left in a corporation once creditors have been fully paid out (accumulated and future earnings). Because the payment schedule of bonds is strictly defined, bonds are less volatile. As a rule of thumb, a broad market bond index will likely be three to four times less volatile than a broad market stock index.

e. Investment-Grade vs. High-Yield

About 52% of fixed-income securities are issued by corporations, and 48% by governments. The vast majority of corporate bonds are of investment grade: they carry a credit rating from agencies such as Moody's and Standard and Poor's of AAA to BBB and are considered very likely to make all their promised payments on time. A small percentage of the corporate bond market is of speculative grade (or "high-yield"): they involve a substantial probability of default, but in return, they pay a higher interest rate than do investment-grade securities. These bonds are rated between BB and CCC.

f. Coupon vs. Yield to Maturity

The "coupon" is the fixed nominal interest rate paid by a bond. This name goes back to the days when bonds were actual pieces of paper held by investors. In order to collect their interest payments, investors had to cut a coupon from the bond certificate and deliver it to the custodian on the scheduled date. By contrast, the yield to maturity of a bond is its market interest rate, which fluctuates in an inverse relationship with its price. We will discuss the price/yield relationship in the section on bond pricing. Just keep in mind that the coupon is fixed while the yield to maturity fluctuates with the supply and demand on the market.

g. Maturity Type

Bonds are typically classified as one of three maturity types. Short-term bonds have a term of one to five years. Mid-term bonds bear maturities longer than five years, up to a maximum of ten years. Finally, long-term bonds have maturities extending beyond ten years, often up to thirty years and sometimes even longer.

h. Premium, Discount and Par Bonds

Bonds that are valued at their full face value are said to be "at par." Par bonds trade at a price of $100 per hundred dollars of face value. Bonds that are valued above $100 are said to be "at a premium." Finally, bonds valued below par are "at a discount."

i. Credit Spreads

A credit spread is the difference in yield between a top-quality bond (federal government or U.S. Treasury bonds, for example) and a bond of lesser quality (provincial, municipal or corporate bond).

Now that we have reviewed the "major components" of the bond market, the next section will look at how bond prices and yields are set.

The Author

Raymond Kerzérho MBA, CFA
Director of Research

PWL Capital Inc.
www.pwlcapital.com/author/raymond-kerzerho
raymondk@pwlcapital.com

CONTACT RAYMOND

PWL

www.pwlcapital.com

PWL Montreal
3400 de Maisonneuve O.
Suite 1501
Montreal, Quebec
H3Z 3B8

T 514.875.7566
1-800.875.7566
F 514.875.9611
montreal@pwlcapital.com
www.pwlcapital.com/montreal

PWL Ottawa
265 Carling Avenue,
8th Floor,
Ottawa, Ontario
K1S 2E1

T 613.237.5544
1-800.230.5544
F 613.237.5949
ottawa@pwlcapital.com
www.pwlcapital.com/ottawa

PWL Toronto
8 Wellington Street East
3rd Floor
Toronto, Ontario
M5E 1C5

T 416.203.0067
1-866.242.0203
F 416.203.0544
toronto@pwlcapital.com
www.pwlcapital.com/toronto

PWL Waterloo
20 Erb St. West
Suite 506
Waterloo, Ontario
N2L 1T2

T 519.880.0888
1-877.517.0888
F 519.880.9997
waterloo@pwlcapital.com
www.pwlcapital.com/waterloo