# Chapter Two
# What are bonds and gilts?

The ingenuity of City financiers has produced a wide variety of paper issued by businesses, in addition to ordinary shares.

## Bonds

Shareholders are owners of a company by virtue of putting up the cash to run it, but a good business balances the sources of finance with the way it is used, and some of it can come from borrowing. A part of the borrowing may be a bank loan or overdraft, but to pay for major investments most managers reckon it is wiser to borrow long term. For some of this the company issues a different type of paper – in effect a corporate IOU. The generic name for this sort of corporate issue is 'bonds'. They are tradable, long-term debt issues with an undertaking to pay regular interest (normally at a rate fixed at the time of issue) and generally with a specified redemption date when the issuer will buy the paper back. Some have extra security by being backed by some corporate asset, and some are straight unsecured borrowings. Holders of these must receive interest payments whether the company is making a profit or not. The specified dividend rate on bonds is sometimes called the 'coupon', from the days when they came with a long sheet of dated slips that had to be returned to the company to receive the payment.

Here as elsewhere in the book you will come across words such as 'generally', 'usually', 'often' and 'normally'. This is not a cover for ignorance or lack of research but merely an acceptance of the City's ingenuity. Variants of ancient practices are constantly being invented, and novel and clever financial instruments created to meet individual needs. What is described is the norm, but investors should be prepared for occasional eccentricities or variants.

## *Permanent interest-bearing shares*

The world of finance has its own language, with the problem that words are sometimes used in ways that do not tally with their everyday usage. It is not always intended to confuse the layperson – though it frequently has that effect – but specialist functions need specialist descriptions and even financiers have only the language we all use to draw on. One example is the difference between 'permanent' and 'perpetual'. 'Permanent capital' is used as a label for corporate debt. 'Perpetual' means a financial instrument that has no declared end date. So a perpetual callable tier-one note sounds like a sort of debt but is in fact a sort of preference share. On the other hand, a permanent interest-bearing share is not a share at all but for all practical purposes a bond.

Permanent interest-bearing shares (Pibs) are shares issued by building societies that behave like bonds (or subordinated debt). Pibs from the demutualized building societies, including Halifax and Cheltenham & Gloucester, are known as 'perpetual sub bonds'. Like other building society investments (including deposits) they make holders members of the building society.

They pay a fixed rate and have no stated redemption date, though some do have a range of dates when the issuer can (but need not) buy them back, almost always in the distant future. Sometimes, instead of being redeemed they are switched to a floating-rate note.

They cannot be sold back to the society but can be traded on the stock exchange. Not having a compulsory redemption date means the price fluctuates in line with both prevailing interest rates and the perceived soundness of the issuing organization, which makes them more volatile than most other bonds. If the level of interest rates in the economy rises then the price of Pibs will fall. If interest rates rise, their price falls, but if rates fall, capital values rise. There is generally no set investment minimum, though dealers will trade only thousands of them at a time, and stockbrokers' dealing costs make investments of, say, under £1,000 to £1,500 uneconomic.

Pibs provided yields a couple of percentage points above undated gilts. With demutualization and the subsequent collapse of some building societies the yield has been forced higher to offset the risk. The risk is high because if capital ratios fall below specified levels, interest will not be paid to holders and since interest is not cumulative, it is lost for good. Another problem is that holders of Pibs rank below members holding shares (depositors) at a time of collapse, and, as they are classed as capital holders, are not protected by the Financial Services Compensation Scheme, unlike depositors who are protected for up to £85,000. However, building societies are generally low risk.

The good news is there is no stamp duty on buying these investments; interest is paid gross and though interest is taxable they can be sheltered in an ISA (Individual Savings Account); and, for the moment, they are not subject to capital gains tax. It is also worth bearing in mind that building societies, before greed carries them away into demutualization, are run conservatively, so their funds come mainly from savers rather than the much more volatile and unpredictable wholesale money markets. Having no quoted shares, building societies cannot be destabilized by having the share price undermined by specialized bear gamblers selling short (see Glossary).

## *Loan stocks and debentures*

Bonds that have no specified asset to act as security are called 'loan stocks' or 'notes'. These offset the greater risk by paying a higher rate of interest than debentures, which are secured against company assets. In Britain that is commonly a fixed asset but in the United States it is often a floating charge secured on corporate assets in general.

Interest payments (dividends) on these bonds come regularly, irrespective of the state of the company's fortunes. As the rate of interest is fixed at issue, the market price of the paper will go up when interest rates are coming down and vice versa to ensure the yield from investing in the paper is in line with the returns obtainable elsewhere in the money markets. In other words, the investment return from buying bonds at any particular moment is governed more by the prevailing interest rates than by the state of the business issuing them.

The further off the maturity date the greater the volatility in response to interest rate changes because they are less dominated by the prospect of redemption receipts. On the other hand the oscillations are probably much less spectacular than for equities, where the price is governed by a much wider range of economic factors, not just in the economy but in the sector and the company.

Because the return is fixed at issue, once you have bought them you know exactly how much the revenue will be on the particular bonds, assuming the company stays solvent and the security is sound, right up to the point of redemption when the original capital is repaid. Since there is still that lingering worry about whether any specific company will survive, the return is a touch higher than on gilts (bonds issued by the government, page 11), which are reckoned to be totally safe. So for a private investor this represents a pretty easy decision: how confident am I that this corporation will survive long enough to go on paying the interest on the bonds, and is any lingering doubt offset by the return being higher than from gilts?

If the issuer defaults on the guaranteed interest payments – which is generally only when the business is in serious danger of collapse – debenture holders can appoint their own receiver to realize the assets that act as their security and so repay them the capital. Unsecured loan stock holders have no such option but still rank ahead of shareholders for the remnants when the company goes bust.

There are variants on the theme. A ‘subordinated debenture’, as the name implies, comes lower down the pecking order and will be paid at liquidation only after the unsubordinated debenture. Most of the bonds, especially the ones issued by US companies, are rated by Moody’s, Standard & Poor’s and other agencies with a graded system ranging from AAA for comfortingly safe down to D for bonds already in default.

## *Warrants*

Warrants are often issued alongside a loan stock to provide the right to buy ordinary shares, normally over a specified period at a predetermined price, known as the ‘exercise’ or ‘strike’ price. They are also issued by some investment trusts. Since the paper therefore has some easily definable value, warrants are traded on the stock market, with the price related to the underlying shares: the value is the market price of the share minus the strike price.

They can gear up an investment. For instance, if the share stands at 100p and the cost of converting the warrants into ordinary shares has been set at 80p, the sensible price for the warrant would be 20p. If the share price now rises to 200p, the right price for the warrant would be 120p (deducting the cost of 80p for converting to shares). As a result, when the share price doubled the warrant price jumped six-fold.

This type of issue is in a way more suited for discussion under the heading of ‘derivatives’, alongside futures and options in Chapter 3.

## Preference shares

Preference shares can be considered a sort of hybrid. They give holders similar rights over a company's affairs as ordinary shares (equities), but commonly holders do not have a vote at meetings; like bonds they get specified payments at predetermined dates. The name spells out their privileged status, since holders are entitled to a dividend whether there is a profit or not, which makes them attractive to investors who want an income. In addition, for some there is a tax benefit to getting a dividend rather than an interest payment. No dividend is allowed to be paid on ordinary shares until the preference holders have had theirs. They rank behind debenture holders and creditors for pay-outs at liquidation and on dividends. If the company is so hard up it cannot afford to pay even the preference dividend, the entitlement is 'rolled up' for issues with cumulative rights and paid in full when the good times return. Holders of preference shares without the cumulative entitlement usually have rights to impose significant restrictions on the company if they do not get their money. Sometimes when no dividend has been paid the holders get some voting rights.

Like ordinary shares they are generally irredeemable, so there is no guaranteed exit other than a sale. If the company folds, holders of preference shares rank behind holders of debt but ahead of the owners of ordinary shares.

There are combinations of various classes of paper, so for instance it is not unknown for preference shares also to have conversion rights attached, which means they can be changed into ordinary shares.

## Convertibles

Some preference shares and some corporate bonds are convertible. This means that during their specified lives a regular dividend income is paid to holders, but there is also a fixed date when they can be transformed into ordinary shares – conversion is always at the owner's choice and cannot be forced by the issuer.

Being bonds or preference shares with an embedded call option (see Chapter 3), the value is a mixture of the share price and hence the cost of conversion, and the income they generate.

## Gilts

The term is an abbreviation of 'gilt-edged securities'. The suggestion is that of class, distinction and dependability. The implication is that these bonds issued by the British government are safe and reliable. There is some justification for that: the government started borrowing from the City of London in the 16th century, and it has never defaulted on either the interest or the principal repayments of any of its bonds. Although gilts are a form of loan stock not specifically backed by any asset, the country as a whole is assumed to stand behind the issue and therefore default on future gilts is pretty unlikely as well – the risk is reckoned to be effectively zero.

Gilts exist because politicians may think tax revenues are suffering only because the economy is in a brief dip and they want to bridge that short-term deficit, or they dare not court voter disapproval by raising taxes to cover state expenditure. The difference between revenue and expenditure is made up by borrowing – this is the Public Sector Borrowing Requirement or government debt, much discussed by politicians and the financial press. In effect it passes the burden to future generations who pay interest on the paper and eventually redeem it (buy it back at a specified date).

The issues have a fixed rate of interest and a stated redemption date (usually a range of dates to give the government a bit of flexibility) when the Treasury will buy back the paper. The names given to gilts have no significance and are merely to help distinguish one issue from another.

The interest rate set on issue (once again called the 'coupon') is determined by both the prevailing interest rates at the time and who the specific issue is aimed at. The vast majority of the gilts on issue are of this type. In addition there are some index-linked gilts and a couple of irredeemables including the notorious War Loan – people who backed the national effort during the Second World War found the value of their savings eroded to negligible values by inflation. This is still on issue and the financial crash of 2008 stopped it being a joke as it gained new life in the low-interest environment.

There is a long list of gilts being traded with various dates of redemption. For common use these are grouped under the label of 'shorts' for ones with lives of under five years, 'medium-dated' with between five and 15 years to go, and 'longs' with over 15 years to redemption. The government has also been issuing ultra-long gilts with up to 50 years to redemption. On the whole these are probably more aimed at and suitable for investors such as pension funds and insurance companies, which need assets to match the longer lives of pensioners.

In newspaper tables there are sometimes two columns under ‘yield’. One is the so-called ‘running yield’, which is the return you would get at that quoted price, and the other is the ‘redemption yield’, which calculates not just the stream of interest payments but also the value of holding them to redemption and getting them repaid – always at £100 par (the face value of a security). If the current price of the gilt is below par the redemption yield is higher than the running yield, but if the price is above par (which generally suggests it is a high-interest stock) one will lose some value on redemption so the return is lower.

Since the return is fixed at issue, when the price of a bond like gilts goes up, the yield (the amount you receive as a percentage of the actual cash invested) goes down. Let us assume you buy a gilt with a nominal face value of 100p (yes that is £1, but the stock market generally prefers to think in pennies), and with an interest rate of 10 per cent set at issue. If the current price of that specific gilt is 120p, you would get a yield of 8.3 per cent (10p as a percentage of the 120p paid). If the price of that issue then tumbles and you buy at 80p you could get a yield of 12.5 per cent (10p as a percentage of 80p).

There are other public bonds of higher risk than UK gilts. These include bonds issued by local authorities and overseas governments. Calculations used to be straightforward when many decades of stability suggested neither local authorities nor foreign government would become insolvent. The 2008 crash and subsequent financial turbulence in many countries woke up the market to the fact nothing can be taken for granted – not even sovereign debts are always safe, especially from countries with large deficits. It has indeed happened before as any collector of unredeemed bonds will testify. Chinese governments, Tsarist Russia, US states, Latin American enterprises and so on have all issued beautifully engraved elaborate bonds that are now used to make lampshades or framed decorations for the lavatory, because they were never redeemed. On overseas bonds there is also the added uncertainty from currency movements.

As always, and this is an important rule to remember for all investments, the higher the risk the higher the return to compensate for it. So if something looks to be returning fabulously high dividends it must be because it is – or it is seen to be – a fabulously high-risk investment.

In the case of public bonds the higher risk than UK gilts means local authority and foreign government bonds provide a higher yield, varying with the confidence in the countries' financial stability, and corporate bonds sometimes slightly higher still, depending on the issuer and guarantor (often a big bank). The differences are generally marginal for the major, safe issuers, seldom much more than 0.3 per cent.