Prudential Investment Managers
OCTOBER 2020

Asset classes explained: A closer look at bonds

In part 1 of our series on asset classes, we explored arguably the most well-known asset class of them all - equities – explaining how they work and how fund managers use them to generate returns for their clients. In part 2 of our series, we take a closer look at one of the lesser-known asset classes – bonds – and discover that they're a lot more interesting and useful than what they may appear on the surface.

What are bonds?

Bonds are a form of loan agreement between two parties. When you buy a bond, you are essentially lending money to that entity so it can raise funds to finance spending, with the promise that you'll receive regular interest payments plus a final full repayment after a certain period (typically one year or more).

There are broadly two types of entities that issue bonds, namely the government and companies. Bonds issued by governments are called government bonds, sovereign bonds or gilts. When a government spends

more on health, education, infrastructure etc. than it receives in taxes, it needs to borrow the difference by issuing bonds.
Bonds issued by companies are called corporate or credit bonds, and are typically issued to finance operational expansion and other capital expenditure. Both government bonds and many corporate bonds are listed and traded on public exchanges, which means that they're priced daily and can be easily be bought and sold by investors.

What are the benefits?

Because investors earn interest as a regular income (usually paid out quarterly), individuals who require a high level of income, plus medium- to long-term capital appreciation with relatively low risk, would benefit from investing in bonds or in unit trusts that hold bonds. Inflation-linked bonds are distinguished by the fact that the interest rate they pay is linked to the prevailing inflation rate, and adjusts as that rate moves up or down. These bonds therefore provide investors with some degree of protection against rising inflation.

How do bond prices move?

Bond prices are affected by changes in the interest rate. As interest rates rise, the fixed interest paid by bonds already in existence becomes less attractive than new bonds about to be issued. As a result, their prices fall as investors won't pay as much compared to bonds that take into account the latest interest rate. Simultaneously, as the existing bond prices fall in the market, their yields rise.

The opposite is true when the interest rate falls: when the SARB cuts rates, the existing fixed interest rate paid by the bond becomes more attractive compared to any new bonds issued, and the price therefore rises (and yield falls).

What are the risks?

Bonds come with repayment or credit risk, which is the risk of bond issuers not being able to meet their repayment obligations when the bond matures (or even miss an interest payment). This can be measured by the issuer's credit rating, which grades the likelihood of being able to repay the debt over time. This is assessed by credit rating agencies, and

investment managers like Prudential conduct their own rigorous credit analysis.

Bond prices have historically moved less sharply than equities, making them typically a safer investment option. In addition, companies experiencing financial difficulties are required to first repay bondholders before making any payments to shareholders, thereby adding an extra layer of protection.

One of the mechanisms that fund managers use to reduce portfolio risk, is to balance the asset allocation across both bonds and equities in order to spread (or diversify) these risks.
At Prudential, we offer investors three multi-asset unit trusts with different levels of bond and equity exposure:

- Prudential Balanced Fund
- Prudential Inflation Plus Fund
- Prudential Enhanced Income Fund

and one with a pure bond focus:

- Prudential High Yield Bond Fund

This last fund (the Prudential High Yield Bond Fund) aims to maximise income while securing steady capital growth by investing in a diversified portfolio of high-yield bonds.

The fund invests in a combination of South African government, semi-government and corporate bonds, and other interest-bearing securities. The performance objective is to maximise total returns above the BEASSA All Bond Index.

To find out how much your investment would have been worth today if you started investing in one of our top-performing funds sooner, try our Past Performance calculator. And if you're ready to start investing with us now, you can complete an application form online in under 10 minutes.

For more information please contact your financial adviser. Alternatively, feel free to call our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.