Insights

Equity market instability and low cash interest rates have left savers and investors, both locally and abroad, taking another look at government bonds as a potential area of investment. Government bonds are a popular fixed income instrument; they are generally less volatile than equities and offer higher yields (interest rates) than cash. We look at how government bonds work and how to gain access to this asset class.

What is a government bond?
A government bond is a debt instrument issued by a government to support state spending and obligations. Essentially an investor is lending money to the government and in return receiving interest on that loan. Government bonds are often considered low-risk investments since they are backed by national government.

How do bonds work?
When an investor purchases a government bond, he or she lends government a certain amount of money for an agreed upon period. In return, the investor receives a set level of interest at regular periods, known as coupon payments. On bond expiration, the investor receives the original capital amount invested/lent to the government. Government bonds offer different yields based on the term of the investment. Typically, the longer the funds are lent to government the greater the yield offered to investors. The type of bond described above is known as a “vanilla bond”. Governments also issue inflation-linked bonds, whereby the state pays interest linked to the inflation rate during the investment period instead of interest at a fixed predetermined rate.
Why invest in government bonds?

Government bonds are bought by investors as they provide a predictable income stream in the form of regular predetermined payments. For investors with lower risk appetite, bonds can act as an effective instrument to beat the cost of inflation and provide stable, measurable returns. When held to maturity, investors receive their capital back and thus preserve capital over a fixed period. In times of market uncertainty bonds can also shelter investors from losses and market pullbacks as they behave differently to the equity market (providing the benefit diversification).

Investing in bonds means understanding key bond terms:

- **Coupon**: This is the interest payment to the bond holder. As bonds are fixed income instruments, the coupon will not change after acquiring the bond.

- **Maturity date**: The day of bond expiration, and when the investor receives his or her capital back from government.

- **Face value**: This is the amount the bond is worth when issued, also known as "par" value, and the amount the investor will receive on bond expiration.

- **Yield**: This is a measure of interest that considers the bond’s fluctuating changes in value. There are different ways to measure yield, but the simplest is the annual coupon of the bond divided by the current price.

- **Price**: This is the amount the bond would currently cost on the secondary market. Several factors play into a bond’s current price, including the perceived risk of lending money to government and yields on other instruments. The secondary market is where bonds are bought and sold prior to maturity.
How can investors buy government bonds?
SA government bonds are issued by National Treasury. Usually, a large investment is required to buy bonds directly from Treasury (in what is referred to as a primary issuance) but there are various ways to buy bonds in the secondary market. Investors also have the option of buying retail savings bonds.

- **Buying bonds directly through a stockbroker:** SA government bonds trade on the JSE bond exchange and can be bought and sold between maturity dates through a stockbroker. Sometimes investors will be able to buy bonds at prices lower than face value and will then receive a higher yield than they would have received if they bought the same bonds directly from Treasury.

- **Bond exchange-traded funds (ETFs):** Bond ETFs track a basket of South African government bonds with varying maturities and yields. Instead of receiving an income, however, the regular payments made by government is reinvested in the index. Investors can buy either a vanilla bond ETF like the SATRIX SA Bond ETF or an inflation-linked bond ETF like the Ashburton ILBI ETF. Investors can even buy bonds issue by other governments through the Ashburton World Government Bond Index. Bond ETFs are listed on the JSE and can be bought and sold easily through a stockbroker.

- **Bond unit trusts:** This is a collective investment structure that can hold a wide range of South African government and even corporate bonds selected by professional investors. Unit trusts are another liquid investment vehicle, which means that investors can enter and exit the fund easily. Bond unit trusts can be purchased through a linked investment service provider (LISP).

- **RSA retail savings bonds:** This is another direct way for an individual to invest in SA government bonds. The minimum investment amount is R1 000. RSA retail bonds offer yields linked to SA government bonds, and are available with two-, three- or five-year fixed terms. Investors can either purchase vanilla bonds or inflation-linked retail bonds. Interest is payable semi-annually on set payment dates until maturity of the bond.
These bonds can be acquired at the South African post office or online through https://secure.rsaretailbonds.gov.za. A major drawback of these bonds is that they cannot be sold in the secondary market, so investors will be tied into the investment until maturity.

How have bonds performed in the past?
Over the last five years, bonds have performed better than equities but over the very long term it usually delivers weaker returns than these traditional growth asset classes. It is also important to realise that we have seen strong recovery in bonds more recently and at what price you buy or sell in the secondary market has a very important impact on your returns experience.

### Total Return

<table>
<thead>
<tr>
<th></th>
<th>YTD (8 June 2020)</th>
<th>1 Year</th>
<th>5 Years (pa)</th>
<th>10 Years (pa)</th>
<th>15 Years (pa)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SA Listed Property</td>
<td>-32.0%</td>
<td>-31.3%</td>
<td>-6.3%</td>
<td>5.9%</td>
<td>10.5%</td>
</tr>
<tr>
<td>JSE All Share Index</td>
<td>-3.5%</td>
<td>-2.3%</td>
<td>4.4%</td>
<td>10.9%</td>
<td>12.9%</td>
</tr>
<tr>
<td>All Bond Index</td>
<td>1.0%</td>
<td>6.6%</td>
<td>7.8%</td>
<td>8.4%</td>
<td>8.1%</td>
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<tr>
<td>Cash (STEFI)</td>
<td>2.9%</td>
<td>7.0%</td>
<td>7.2%</td>
<td>6.5%</td>
<td>7.3%</td>
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Our current view on bonds
Bond prices have gone up more recently and bond yields have come down, which means that vanilla bonds are no longer as attractively priced as they were a few months ago. Our assessment of the asset class is currently neutral. South African government bonds could receive further support because they still offer a higher yield than other countries’ bonds – particularly in the developed world. Conversely, government has been issuing more debt and recent fiscal interventions to lessen the impact of Covid-19 will result in government’s debt burden increasing, thereby placing downward pressure on
government bond prices as investors demand higher yields to invest. Currently, inflation-linked bonds appear slightly more attractive than vanilla bonds.

Regardless of point valuations, bonds hold diversification benefit and should form an important part of any investment portfolio.

ENDS