**DEMYSTIFYING THE BASICS OF CORPORATE BOND.**

The first think that comes to most people's minds when they think of investing is the stock market. After all stocks are exciting. Stories of investors gaining great wealth in the stock market are common. Bond's on the other hand do not have the same appeal. The Bond issue seems complex and confusing to the average person. Plus bonds are much more boring especially during raging bull markets when they seem to offer a lower return compared to stocks.

Just as people need money so do companies and governments. A company needs funds to expand into new markets, while government needs money for everything from infrastructure to social programs. The problem large organizations run into is that they typically need far more money than the average bank can provide. The solution is to raise money by issuing bonds (or other debt instruments) to the capital market. Thousands of investors then each lend a portion of capital needed. Every stock investor should know about bonds. Bonds are the other sides of the investing coin that may help keep your portfolio afloat in troubled times. If you own stock in a company you are a part owner or a shareholder of the company. As a bondholder you are a creditor.

A bond is just an organization's IOU i.e. a promise to repay a sum of money at certain interest rate and over a certain period of time. In other words a Bond is a debt instrument. When a company issues bonds, it is borrowing money from investors in exchange for which it agrees to pay them interest at a set interval for a predetermined amount of time. In essence it is the same thing as a mortgage only you the investors are the bank. Really a bond is nothing more than a loan for which you are the lender. The organization that sells a bond is known as the issuer.

The issuer of the bond must pay the investors something extra for the privilege of using his or her money. This "extra" comes in the form of interest payments, which are made at a predetermined rate and schedule. The organization will agree to pay some interest rate on the bonds and further agree to redeem the bonds (i.e. buy them back) at some time in the future (redemption date). But note that there are some bonds, which don't make regular interest payments, and they are called zero-coupons bonds. As the name suggests these are bonds that pay no coupon or interest payment. Instead of getting an interest payment you will buy the bond at a discount from the face value of the bond and you are paid the face amount when the bond matures.

The interest rate is often referred to as the coupon. The date on which the issuer has to repay the amount borrowed known as face value (or par value) is called maturity date. Bonds are known as fixed-income securities because you know the exact amount of cash you will get back if you hold the security until maturity.

A bond prices is subject to market forces and often fluctuates above or below par. If you sell a bond before it matures you may not receive the full principal amount of the bond and will not receive any remaining interest payments. This is because a bonds price is not based on the par value of the bond. Instead the bond's price is established in the secondary market and fluctuates. As a result the price may be more or less than the amount of the principal and interest and the remaining interest the issuer would be required to pay if you held the bond to maturity. The price of a bond can be above or below its par value for many reasons including interest rate adjustments, whether a bond credit rating has changed, supply and demand, a change in the creditworthiness of a bond's issuer, whether the bond has been called or is



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likely to be or not be called, change in the prevailing market interest rates and a host of other factors. If a bond trades at par it is said to trade at premium while if a bond trades below par it is said to trade at a discount.
On the redemption date, bonds are usually redeemed at “par” meaning the company pays back exactly the face value of the bond. Most bonds allow the issuer to redeem the bonds at nay time before the redemption date, usually at par but sometimes at a higher price. This is known us “calling” the bonds and frequently happens when interest rates fall because the company can sell new bonds at a lower interest (also called the “coupon”) and pay off the older more expensive bonds with the proceeds of the new sale. By doing so the company may be able to lower their cost of funds considerably.

Yield is a general term that relates to the return on the capital you invest in the bond. The terms are important to understand because they are used to compare one bond with another to find out which is the better investment.
There are two concepts that are important to understand with respect to corporate bonds. There are classifications of bond based on a bond’s relationships to a corporation capital structure. In this ranking structure we have secured corporate bonds and unsecured corporate bonds. Secured bonds are backed by collateral that the issuer may sell to repay you if the bond defaults before or at maturity. For example a specific factory or a piece of industrial equipment might back a bond. While unsecured bonds are backed only by the promise and good credit of the bond’s issuer (this is the most common corporate bond issued in Kenya).

You often hear the term basis points-bps for short-in connection with bonds and interest rates. A basis point is one one-hundredth of a percentage point (.01). One percent is equal to 100 basis points. One half of one percent is equal to 50 basis points. Bond traders and brokers regularly use basis points to state concise differences in bond yields. We also have fixed and fluctuating rate bond. Fixed-rate bonds are bond’s where the interest rates remains constant throughout the life of the bond i.e. East Africa Development Bank Bond. While floating rate bonds are bonds with a variable interest rate that is tied to a benchmark such as money market index, 91-day government of Kenya Treasury bill rate. The ‘coupon” is then periodically reset normally every three or six months. Examples of such bonds are; Mabati Rolling Mills floating rate notes, Faulu Kenya floating rate notes and the recently listed PTA Bank Limited floating rate bond. The following are the cardinal rules and facts about bonds. The first is when interest rates rise bond prices fall. Second is that when interest rates fall bond prices rise. Third is that every bond carries interest rate risk. Fourth is that nobody can give you a bond’s actual total return ahead of time. It can only be figured after the bond has matured or is sold. Fifth Bond price and yield are inversely related. As the price of a bond goes up its yield goes down and vice versa.