

Insights

Understanding Bond Market Volatility

Most investors are aware that bond prices fluctuate. But what causes bond prices to move up and down? For the most part, the fluctuation is due to changes in interest rates, as well as changes in a bond's credit quality.

How Changes in Interest Rates Impact Bonds

Since the late 1970s, the single largest factor impacting bond prices has been interest rates. Still, many investors do not fully understand how changes in interest rates affect bond prices. Let's look at how bond investments are affected by interest rate fluctuations.

The general rule of thumb is that as interest rates go up, bond prices go down, and vice versa. Let's look at an example of how the relationship between interest rates and bond prices works. An investor buys a 10-year US Treasury bond at US\$ 1,000 at a time when yields are 4%. A year later, when he wants to sell the same security, yields are 7%. In this higher interest rate environment, the seller will have a tough time convincing a buyer to accept the 4% coupon when the buyer can simply purchase a new 10-year US Treasury bond that yields 7%. The frustrated seller will be forced to reduce the price of the bond to US\$ 817 in order to sell it. In total return terms, the 3% increase in the bond's yield represents a price drop of -18%. Taking the coupon payments into consideration, the bondholder would expect a negative 14% total return for the instrument for the year. As you can see, interest rates and bond prices move in opposite directions.

Factors Affecting Interest Rate Movements

This leads us to look at why rates fluctuate. Among the main reasons: supply and demand for loans, a central bank's monetary policy and inflation levels. In simple terms, if the demand for loans is higher than the general supply of funds available, the bank can raise lending rates or borrow money from others by issuing bonds to institutions. Since borrowing from other institutions is relatively more expensive, the mortgage bank adjusts its rates higher.

In terms of monetary policy changes, when a government lowers rates (loosens monetary policy), it generally does so to make more cash available to lenders and borrowers, with the underlying intention of boosting the economy. When a government raises rates (tightens monetary policy), one of the reasons it does so is to slow down an economy that may be growing too fast.

How Credit Ratings Impact Bonds

Investors rely on bond ratings to evaluate the credit quality of specific bonds. Credit ratings indicate the probability that the debt will not be repaid in full (likelihood of default).

For example, blue-chip companies tend to be considered safer investments and usually have a higher rating than other bonds. The chart below illustrates the different bond rating scales from the major rating agencies in the United States. For debt issued by a country, a few of the reasons a bond's rating may be upgraded or downgraded include: a macroeconomic change affecting the country's trade or foreign investment policy, politics or foreign relations. For debt issued by a company, some of the reasons include: corporate strategy, the macroeconomic environment and general credit conditions.

Bond Rating			
Moody's	S&P	Grade	Risk
Aaa	AAA	Investment	Highest Quality
Aa	AA	Investment	Highest Quality
A	A	Investment	Strong
Baa	BBB	Investment	Medium Grade
Ba, B	BB, B	High Yield	Speculative
Caa/Ca/C	CCC/CC/C	High Yield	Highly Speculative
	D	High Yield	In Default

Notice that if the issuer falls below a certain credit rating, its grade changes from investment quality to high-yield status. High-yield bonds are the debt of companies in various degrees of financial difficulty. Since they are relatively riskier investments, they offer much higher yields than other kinds of debt.



Bond Mutual Funds Vs. Individual Bonds

Few people realise that a bond mutual fund does not behave exactly like an individual bond. Most importantly, a bond fund's dividends are not fixed, whilst the dividend payments are fixed on an individual bond. With a bond mutual fund, the dividend income could rise or fall with changing interest rates, or as cash flows into and out of the fund as investors purchase or redeem shares.

When does it make sense to purchase individual bonds rather than bond funds? Investors looking primarily for an income stream sometimes choose to buy and hold individual bonds — oftentimes until they mature. With this type of long-term investment, as long as the bond's credit quality does not change, fluctuations in interest rates are unimportant.

However, bond funds offer a few important advantages over individual bonds that make them attractive to investors who are looking for asset allocation and diversification. This includes the fact that bond funds are professionally managed, which means that the portfolio manager can choose the right maturity or type of bond to hold in the fund — at the right time — in order to maximise the bond fund's overall return potential. Since bond funds generally hold a number of individual bonds, they also bring diversification to an investor's overall portfolio, since the risk of any single bond instrument defaulting is spread out among many individual bonds.

Conclusion

As you can see, when evaluating an individual bond or bond fund, it is important to understand some of the key factors that can impact your investment. Only then will you be able to determine what makes sense to include in your overall portfolio.

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