

HOW BONDS WORK



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The Basics of Bonds

When you buy a bond, you are lending money in exchange for a fixed set of cash flows. Those cash flows do not change, but the *price investors are willing to pay for them does*.

The easiest way to think about a bond is to separate **what is fixed** from **what moves**. The income payments and final repayment are agreed upfront. The price moves because the market constantly reassesses what return is “fair” under current conditions.

This is why bonds can show capital gains and losses even though nothing has gone “wrong” with the bond itself.

Term	Definition
Issuer	The borrower (e.g. government or corporation) that promises to make interest payments and repay capital.
Face Value (Par Value)	The amount of capital that will be repaid to the investor at maturity, typically R1 000.
Coupon	The fixed interest rate paid on the bond, expressed as a percentage of face value.
Coupon Payment	The actual cash interest paid each year (e.g. 5% on R1 000 = R50 per year).
Maturity	The date on which the bond expires and the face value is repaid to the investor.
Market Price	The amount investors are currently willing to pay for the bond in the market. This can be above or below face value.
Yield	The return an investor earns based on the bond’s price, coupon, and time to maturity.

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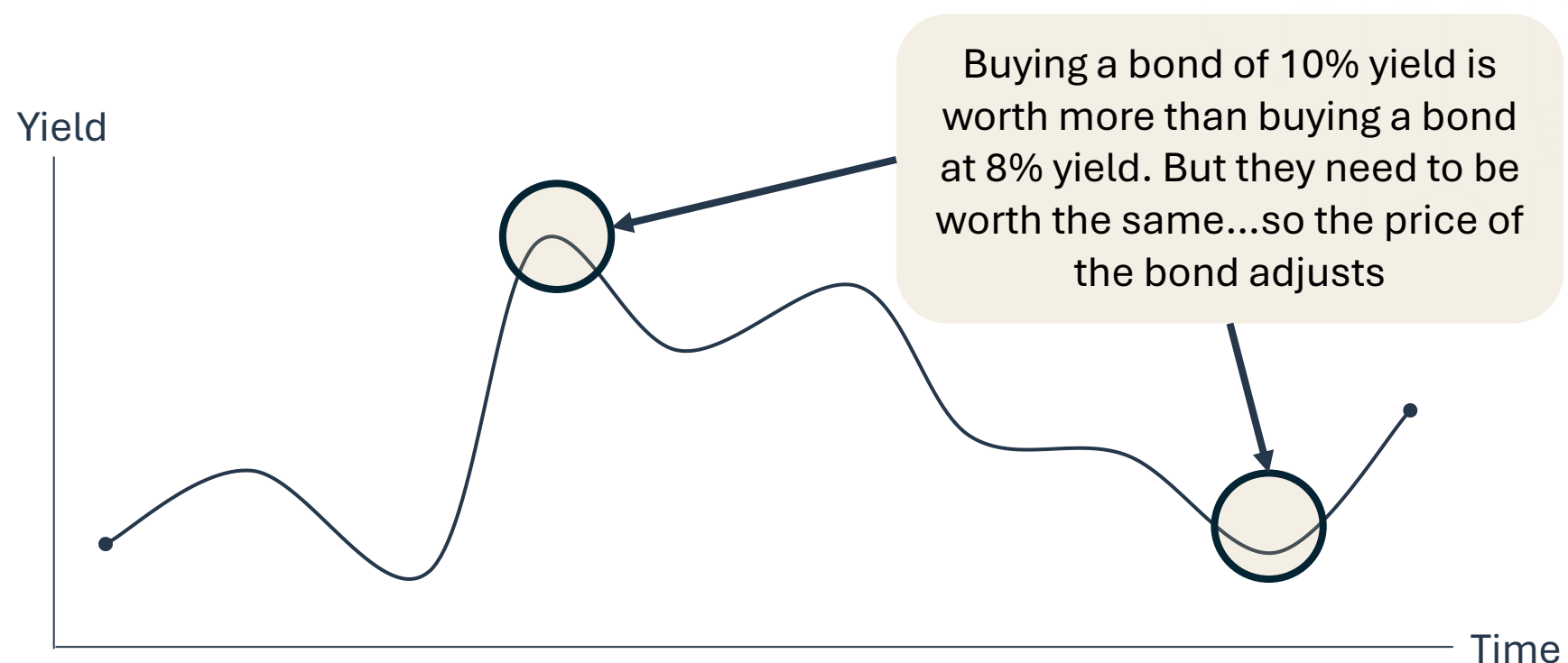
Bonds and their price

If you look at a 10-year bond with a face value (price) of R1 000 and a 10% coupon (yield). It pays R100 per year and returns R1 000 at maturity.

When market interest rates are also 10%, the bond trades close to R1 000. At that point, investors are indifferent between buying this bond or a newly issued one.

If interest rates rise, new bonds offer higher income. The only way the older bond can compete is by adjusting its “price” and becoming cheaper. If rates fall, the opposite happens, the bond’s higher income becomes more valuable and its price rises.

Nothing about the bond changes, only the return investors require.



A Simplified Example:

Bond Price = R1 000

Annual Coupon = R100 (= 10% yield)

Market rates adjust to 11%

Coupon stays the same @ R100

Price must now reflect that R100 coupon = 11% yield

Price = $100 / 11\% = R909$

Capital Return = - 9.09%

Income Return = 10.00%

Total Return for that Year = 0.91%

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The Smartest People in the room

Bond prices react far more efficiently than equity, giving the bond markets the nickname of “the smartest man in the room”. Bond prices don’t only move with interest rate movements but also move during market shocks, even when central bank policy rates remain unchanged. These moves reflect changes in perceived *risk*, not policy.

If inflation expectations rise, investors worry about losing purchasing power and demand higher returns. If credit conditions deteriorate, investors demand compensation for default risk. During liquidity events, investors sell assets simply to raise cash.

All of these impact bonds: as the capital prices move to adjust a fixed income stream to a new required return.

Examples of shocks that can impact prices	Major area of concern for bond investors	Bond Price Effect
Inflation surprise	Real return expectations	↓
Credit stress	Default risk	↓
Liquidity panic	Cash needs	↓
Flight to safety	Capital protection	↑

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What is Duration

Duration is a term bond managers use to show how sensitive a bond's price is to changes in interest rates. A 30-year bond will react much more to interest rate changes than a 1-year bond, because its price has to adjust for 30 years' worth of interest rate changes into the same R1 000 starting price.

How to Funds manage Duration

Interest rates work in cycles, where central banks cut and hike interest rates over many year periods. Holding bonds that will increase their price significantly during interest rate cutting cycles can help make profits in the capital price of the bonds.

Then holding bonds less sensitive to changes in interest rates, during interest hiking cycles allows funds to manage capital losses.

How to Funds manage Credit Risk

Credit risk refers to the chance a company could default on its credit loans. Now credit also moves in cycles (also called spreads). When the economy is strong, managers can take on more risk by holding lower-quality bonds that offer higher income, as defaults are less likely.

When conditions weaken, managers shift back into higher-quality bonds to reduce the risk of losses. They also keep a close eye on issuers and will sell early if a company's bond starts to look risky.

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What clients experience

Income funds aim to deliver steady, reliable returns by actively balancing duration, credit risk, and credit spreads as market conditions change. Managers will take on more duration when rates are falling and keep it shorter when rates are rising.

They also adjust credit exposure by leaning into higher-yielding bonds when the economy is strong and moving to safer assets when risks increase.

Cautious by design

The goal for income funds isn't to chase high returns, but to protect capital while earning a consistent yield through the cycle. A good income fund should feel like a boring, dependable engine...quietly compounding returns over time without taking on unnecessary risk.

Custodian BCI Income Plus

These are some of the tools that we have used to manage our own Custodian BCI Income Plus Fund for more than a decade.

Successfully remaining a top quartile Income fund, and we continue to dedicate our time to safeguarding client assets.

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CONTACT US

+27 (0)21 154 0001

admin@custodian.co.za

www.custodian.co.za



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