Henderson
GLOBAL INVESTORS

The Henderson Guide to

Fixed Income

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Introduction

They may not be as widely traded, or as easily understood as equities, but as an asset class no sensible investor can afford to ignore bonds. At one level bonds provide an invaluable way of diversifying risk within a balanced portfolio – their relative lack of correlation with other assets such as equities and property means they can offer some protection against falls in those markets.

A further benefit of bond investing is the considerable variety of different types of bonds now on offer, from the relatively low risk of government or sovereign bonds through to higher risk emerging market debt. This diversity gives the canny investor an opportunity to generate returns whatever the economic backdrop; whatever your attitude to risk there will almost certainly be a bond matched to your particular outlook.

Yet many investors remain wary of bonds, put off by the apparent complexity involved. And although it is true that bond investing can be a complicated business, the underlying concepts are relatively simple.

This guide aims to cut through the jargon and offers a simple guide to the fixed income market, including details on how bonds work, the different types of bonds on offer, and the various factors affecting their price.

What is a bond?

Put simply, a bond is an IOU – a piece of paper which represents a loan of cash made for a fixed term. The issuer of a bond promises to repay the bond holder the full amount borrowed at a pre-agreed date in the future, and in the intervening period to pay regular interest payments to compensate for the money lent.

However, it is only ever a promise, and every bond carries with it the risk – however small – that the issuer will run into difficulties and be unable to meet those promises. When an issuer fails to pay out cash in accordance with the pre-agreed rules of the bond it is said to be 'in default'. Default risk is one of the main factors to consider when investing in bonds, and in general the higher the perceived default risk the higher the interest payments on offer, as this is the only way that riskier companies can persuade bond investors to part with their cash. We will return to default risk in the 'understanding credit ratings' section.

Some bonds are issued by national governments such as those in the UK, US or Japan. These are usually considered the safest types of bonds, as there is relatively little risk that the governments of these countries will fail to meet their financial obligations. Bonds are also issued by companies (known as 'corporate bonds') such as Tesco or Ford, and these are considered more risky than government bonds as companies carry a greater potential risk of default. To offset this additional risk, corporate bonds typically pay higher interest rates than government bonds. Other types of organisations, such as the World Bank or the European Investment Bank, can also issue bonds.

Bond – a promise made that money loaned will be repaid in full at a later date.

Of course, bonds are not the only types of loans available – companies could, for instance, choose to go to a bank to raise funding. But from an investor's point of view, the key thing that distinguishes bonds from other types of loans is that they are 'transferable', meaning that they can be sold on to another willing buyer.

This means that whoever holds a bond at any moment is entitled to current and future interest payments, and – if they hold on to it until maturity – the repayment of the original loan. So put another way, there is no obligation on the initial buyer to hold onto the bond until the loan period ends (though in some cases they might decide to do this). Bond fund managers will look to buy and sell a portfolio of bonds by buying in the primary market (ie. when they are first issued) and through buying and selling second hand bonds in the secondary market.

In the secondary market the price of any bond can change at a moment's notice, depending on any number of factors. This is where the skill of a good fund manager comes in – predicting the way that the price of a bond is likely to move in the future. The objective is the same as with any asset – buy low and sell high. But with bonds, capital appreciation is just one factor – income received also needs to be considered.

A bond is a financial agreement between two parties over a fixed term

Key features of bonds

Most bonds are structured in a similar way, and there is a well-established terminology used to describe the key features of bonds. The key terms are as follows:

The **'principal'** or **'face value'** or **'par value'** of a bond is the amount of money the issuer has borrowed and promises to pay back when the full term of the loan expires. Each individual bond represents a fixed amount of loan, say £100. When this loan amount is finally repaid it is said to be 'redeemed'.

The **'coupon'** is the term used to describe the interest payments promised by the borrower (or **'issuer'**) to the holder of the bond. Most often this is paid annually on a set date, though some bonds pay interest twice yearly and some others even more frequently. Either way, the coupon is usually expressed as a percentage of the nominal or face value the investor paid for the bond at outset to give the **'nominal yield'**.

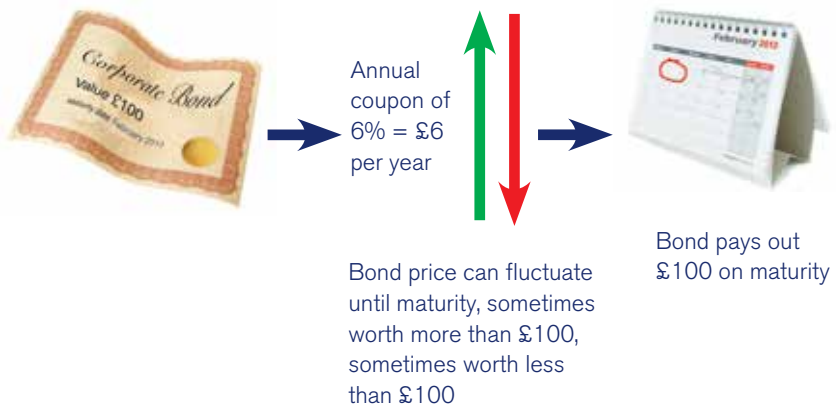
The **'maturity'** or **'redemption'** date is the date at which the borrower has promised to repay the principal to the holder of the bond (whoever that may be). Some bonds are issued with a maturity date a year away; while other maturity dates can be much longer – perhaps ten, twenty or even thirty years or longer. There are even a few bonds (those issued by the UK Government in the Second World War) which have no maturity date at all and promise to keep paying interest for ever. These are called 'perpetual bonds'.

The **'bond yield'** or **'running yield'** is the annual interest payment as a percentage of the price of a bond at any given moment. It differs from the fixed coupon nominal yield because the price of a bond rises and falls, therefore affecting the yield. Yield and price move in opposite directions: when a bond's price rises, its yield will fall. This is because the coupon payments will equal a smaller proportion of the price paid. The opposite is also true: if a bond's price falls, the coupon payments will be a bigger proportion of the price paid; the yield increases relatively.

The **'yield-to maturity'** is an investor's total return expressed as an annual yield if he purchases a bond at any point and then holds it to maturity – i.e. coupon payments plus principal. To professional investors, yield-to-maturity is more important than price because it enables them to compare bonds with different coupon rates and maturity dates. Because it takes into consideration any capital gain or loss, yield-to-maturity will fluctuate with the bond's price.

How investing in a bond works

If an investor buys a bond with a face value of £100, an annual coupon rate of 6% and a life of five years, the investor knows they will be paid £6 interest every year for five years. At the end of the five years, on the maturity date, the investor will be repaid their £100 investment.



Note: Many bonds pay coupons semi-annually, so in the case highlighted above investors would receive £3 every six months over the five-year period

Understanding credit ratings

A bond's credit rating is an assessment of credit quality, carried out by ratings agencies such as Standard & Poor's and Moody's.

Credit ratings help investors assess the risk of default on a particular bond issue. Usually this is directly linked to the creditworthiness of the company or government issuing the bond, although other factors can also come into play.

The highest quality bonds available (for example UK government bonds) are rated AAA, the next tier down AA, then A, and then further down to BBB, BB etc. These ratings follow the lettering convention used by Standard & Poor's (S&P), a leading credit rating agency. Bond ratings can change as the issuer's circumstances change – they are either 'upgraded' (designated lower risk than before) or downgraded (considered to be of higher risk). Investors willing to purchase a bond receive a rate of return (or 'yield') intended to compensate them for the level of risk they are prepared to take.

Different bonds carry different ratings

The simplest way to establish a company's likelihood of defaulting on a bond payment is through its credit rating.

The relationship between bond ratings and yield

The higher a bond's rating, the greater its quality. A highly rated bond will be deemed a lower risk investment, and will therefore be offered to investors at a lower yield.

A bond with a lower rating will have a greater yield, to help compensate investors for the additional risk they take on. However, if the bond defaults the holder of the bond can lose their entire investment.

Long term credit rating definitions

S&P	Moody's	Quality	Category
AAA	Aaa	Highest quality	Investment Grade
AA	Aa	High quality	
A	A-1, A	Upper medium	
BBB	Baa-1, Baa	Medium	
BB	Ba	Speculative	Non Investment Grade
B, CCC, CC	B, Caa	Highly speculative	
C, D	Ca, C	In Default	

Bonds with a rating of BBB or higher (or equivalent) are termed 'investment grade', and those below as 'sub-investment grade' or 'high yield' (an old term – but perhaps slightly misleading – is 'junk bonds'). Bonds that do not have any rating are known as 'unrated' – sometimes this is because they have chosen not to pay for an assessment, or because they are considered too high a risk to qualify for an official rating. Many investors are wary of unrated debt for obvious reasons.

Who should be buying fixed income?

Investors have traditionally held larger proportions of bonds in their portfolios as they have become older, as a regular stream of income payments is ideal for those reaching retirement age and looking to preserve the capital value of their savings.

Bonds are also typically considered to be lower risk than equity investments, which are more widely traded and more prone to changes in investor sentiment. As we mentioned earlier, a bond is a promise from a company to repay a debt. A share is a part-ownership in a company, the value of which can rise or fall. It is also worth remembering that if a company goes bust, bondholders have a stronger claim to whatever assets are left in the company when compared to equity investors.

Risk versus return

Because bonds are considered to be less risky than equities, the potential returns are lower. Bonds do not share in the profits of a company in the same way as shares do. While shareholders might enjoy rising dividend payments as the company grows and becomes more successful, the bondholder is limited to the coupon agreed at the outset. In strong markets for equities this can be frustrating, but demonstrates that bonds can be a sound investment during periods of equity market weakness.

The price of bonds can still fluctuate – even though the coupon and principal remain the same. But price fluctuations can create excellent opportunities for the knowledgeable investor. As any experienced fund manager will tell you: volatility equals opportunity.

Bonds and equities display several distinct and different characteristics.

Investors thinking about investing in bonds should first consider their long-term investment objectives. An independent financial adviser (IFA) will be able to help determine what these are. But investors looking for a regular income and consistent return on their investment – without the thrills and spills sometimes associated with equities – should consider setting aside a significant proportion of their overall investment portfolio to fixed income assets.

Your portfolio's bond allocation may change over time

Different types of bonds

There are a wide variety of different types of bonds to choose from, depending on the investors' attitude to risk. Here is a brief overview of some of the most popular categories:

Sovereign or Government Bonds

These are bonds issued by a national government – in the UK they are known as 'Gilts', in the US as 'Treasuries'. Bonds issued by governments in developed economies are considered the lowest risk, as the chance of the government defaulting on the loan is very low. Indeed, the UK government has never failed to repay a bond loan. However, governments can sometimes face the threat of default, as Greece demonstrated in 2012, when its debt was 'restructured'. Although defaults can and do occur, they are still very rare events. One of the most memorable was the bond default by the government of Argentina in 2001, when the government defaulted on nearly $100bn of loans.

Coupons on government bonds are usually fixed, and their maturity varies between one and thirty years (although even longer-dated bonds have been issued). Because governments are unlikely to default on their debt payments, the main factors affecting government bonds are inflation-risk and interest rate-risk.

Investment grade corporate bonds

These are bonds issued by companies. Unlike sovereign bonds, there is a risk that the issuer of the bond will be unable to meet their obligations in the future (they will 'default'). Corporate bonds therefore pay a higher coupon to compensate for this, and the higher the perceived risk, the higher the interest payments they will offer as a trade-off. The extra return offered to the investor over a similarly-structured government

Different bonds may deliver differing levels of returns

With so many different types of bond available there is something to suit all investors –whatever their attitude towards risk.

Bond portfolios can blend a variety of assets to suit all tastes

bond is known as the 'spread'. The corporate bond market is roughly split into two groups – 'investment grade' and high yield (or 'sub-investment grade'). Investment grade bonds are at the lower risk/ lower return end of the corporate bond market, and here we will typically find the big blue chip companies.

Default rates among investment grade bonds are usually quite low. Investment grade corporate bonds are technically defined as those bonds with a Standard & Poor's rating of BBB or above (or equivalent).

High yield bonds

High yield or 'junk' bonds are considered much riskier, and as a result have to pay much higher coupons to attract investors. High yield bonds typically mature in ten years or less, and are less sensitive to interest-rate changes than government bonds and investment-grade corporate bonds. At the most risky end of the high yield market, bonds can behave more like equities than sovereign bonds. This lack of correlation is useful in providing diversification. High yield bonds are defined as those with an S&P credit rating of BB+ or below. The lower the credit rating, the higher the perceived risk of default.

Inflation-linked bonds

Inflation-linked bonds pay a variable coupon linked to the rate of inflation in the wider economy. These are popular amongst investors looking to protect against the threat of inflation. Inflation-linked bonds are issued by both governments and companies, and are especially popular with institutional investors (e.g., pension funds and insurers) because they know that their cash flows will not erode over time, allowing them to better match their cash flows to their liabilities. Supply can be an issue – the inflation-linked bond market is considerably smaller than the regular government bond or credit markets.

Emerging market debt (EMD)

Countries where the risk of political or economic upheaval is higher than in developed nations issue bonds denominated in the world's major currencies (usually US dollars) to attract foreign investment. This is known as external emerging market debt. Most EMD is rated sub-investment grade, although some of the largest markets – Mexico, Brazil and Russia – have been promoted to investment-grade status in recent years. The higher risk of default, as well as the heightened sensitivity to US interest rates (mainly because they are denominated in dollars but also because these countries often depend heavily on the US as a trade partner) make emerging market debt one of the highest-yielding fixed-income investment opportunities. However, it also carries high risk.

There are some other smaller categories of bonds that are structured in different ways. These include:

Convertible bonds

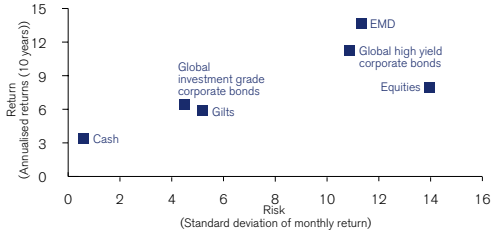
Bonds that may be converted into a company's shares at a pre-determined rate certain pre-agreed times during their life.

Preference shares

Bonds in all but name: their dividends are fixed (just like coupons) and, like bonds, they give shareholders an earlier claim to a company's earnings and assets than ordinary shareholders.

Risks and returns vary

The chart below demonstrates the different levels of risk and return associated with cash investments, equities and various types of bonds over the last 5 years. As you can see, cash was king when it comes to a low risk, low return investment. Investors looking for the highest potential returns (but with the most risk) would have done best by investing in high yield bonds and emerging market debt. Because of the extent of the collapse in equity prices during the 07/08 credit crisis, over this period equities have delivered the lowest return. Importantly, risk and returns will vary over time and the last five years will not necessarily be repeated.



Note: based on 10-year historical returns, returns are hedged into Sterling.
Source: Merrill Lynch, MSCI, Bloomberg and Henderson Global Investors as at 31 December 2012.

What affects the price of a bond?

A bond's total return is made up of two parts:

1. **The income or interest payments (coupon) paid during the life of the bond; and**
2. **The capital gain (or loss) when selling the bond on the market, or if held to maturity.**

There are, however, a number of factors which can affect the price of a bond over the course of its life, and all have the potential to make an impact on your investment.

Inflation

Inflation is bad for bonds. Inflation erodes the real value of the cash promised under the terms of the bond. If the cost of everyday goods rise rapidly, a bond's future fixed coupon and redemption payments buy less of those goods, and so the bond is worth relatively less. In reality, even the threat of inflation tends to depress bond prices, as investors will look to sell bonds and move into assets that appreciate with inflation (for example equities, or property) or inflation linked bonds. Conversely, of course, lower inflation means bonds' fixed payments look more attractive, and so prices typically rise. A bond manager always has one eye on inflation statistics and trends, and has to form a view on what inflation levels are likely to be in the future.

Interest rate movements and inflation play a role in bond pricing

Interest rates are vitally important because they directly affect the attractiveness of bonds.

Interest rates

Interest rates are of course linked to inflation, as most central banks use them as their main tool in fighting price increases in the economy.

But interest rates also affect bond prices in a more direct way. This is because investors can earn interest by investing in a savings account, without needing to take the risk of investing in bonds, although savings deposits are only protected to the value of £85,000 per institution under the Financial Services Compensation Scheme. Interest rates are therefore important to bond prices because they directly affect the attractiveness of bonds – if interest rates and therefore savings rates are high or rising, the fixed coupons on bonds are not as attractive. However, if savings rates are low then the coupons on offer in a bond can look a lot more enticing. For example, if a bond pays a coupon of 5%, and interest rates – the amount an investor receives from depositing his money in a savings account – stand at 2%, the bond's appeal is obvious (an extra 3%). But if interest rates were to rise to 5%, the bond suddenly looks a lot less attractive, because its own rate of interest (coupon payment) is no more than the standard savings rate. The price of the bond therefore falls. Conversely, if interest rates were to then fall to 2%, the bond's 5% coupon suddenly seems more a lot more attractive, and its price rises.

Understanding duration

Duration is an indication of how sensitive a bond's price is to a change in interest rates.

Like a bond's maturity, duration is measured in years, but it also factors in all the cashflows received over the life of a bond (i.e. coupon and redemption payments).

There are two key points to consider:

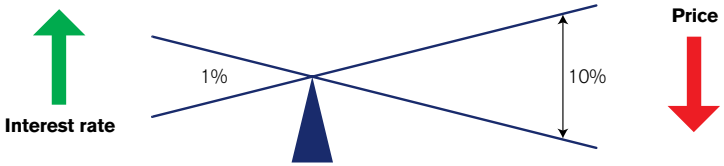
1. **The shorter a bond's maturity, the shorter its duration, and vice versa**
   Cashflows expected in the near term are more valuable than cash flows due in the distant future because an investor can be more certain of receiving them and their value is less eroded by compounded inflation. With a short-maturity bond, a greater proportion of total cash flows are due in the near term, making it quicker for investors to recoup their original investment.

2. **The higher a bond's coupon rate, the shorter its duration, and vice versa**
   In a similar vein, if two bonds have the same maturity, the one with the higher coupon rate will pay investors a greater proportion of total cash flows in the early years. Again, because investors recover their investment faster, the bond has a shorter duration.

As long as an investor receives some cash flow payment prior to the redemption date, the bond's duration will be shorter than its maturity. In the case of zero-coupon bonds – which, as their name implies, do not have periodic coupon payments – duration is equal to maturity because investors receive only one lump-sum payment, on the bond's redemption date.

Why is duration important?

Duration's usefulness is that it determines how sensitive a bond's price is to changing interest rates: for a 1% change in interest rates, the percentage change in a bond's price will be approximately equal to its duration. Remember that bond prices move inversely to changes in interest rates: so, if a bond's duration is 10 years and interest rates were to fall by 1%, the bond's price would rise by 10%; if interest rates were to rise by 1%, the bond's price would fall by 10%. The chart below demonstrates this:



Clearly, the higher a bond's duration, the more sensitive (or volatile) its price will be to a change in interest rates. Therefore, depending on whether interest rates are expected to rise or fall, investors would do better to focus on bonds with particular duration characteristics. If interest rates were expected to fall, investors would normally benefit the most from rising bond prices if they lengthened duration; conversely, if rates were expected to rise, they would limit the negative impact of declining prices by shortening duration.

Bond fund managers take advantage of short term and long term views

The risks associated with bond investing

Every type of investment carries some degree of risk – even cash – and bonds are no exception. This chapter explains these risks in more detail.

Default risk

We have already touched on 'default risk' – the risk that the bond issuer will fail to honour its promises. The judgement a successful bond investor is always making is whether the potential return on a bond is worth the risk involved.

Default risk can sometimes be company specific. Particular firms are clearly more risky than others – small firms with a limited track record, for instance, or companies with a highly geared business strategy. Bond analysts will often conduct extensive research into a company's business plan and report and accounts to assess the likelihood that it will have enough cash to meet its bond obligations in the future. It is worth bearing in mind that the interests of a bond investor are often opposed to those of the shareholder. Bond managers like robust balance sheets with plenty of cash and a strategy that emphasises safety. This is a different viewpoint to most shareholders, many of which expect to see high growth and increasing profits.

It is important to consider your attitude toward risk before investing

Default risk also occurs at a more general level. There is a general risk that applies across a certain industry or sector – banks, for example, are sensitive to increases in lending rates or to regulatory requirements, whilst commodity prices affect resource companies. Bonds in the same sector are often closely correlated for this reason.

Lastly, default risk is also linked to broader macro-economic factors such as the prospect of impending recession. In that scenario default rates shoot up across the market, and so the threat of recession is usually bad news for the price of riskier bonds. Therefore, depending on investors' views on the economy, it might be better to invest in a particular area of the ratings spectrum, for example higher-rated bonds. When this happens it is known as a 'flight to quality'.

It is worth emphasising the market's occasional tendency to judge all bonds en masse – irrespective of an individual issuer's circumstances. This market wide 'sentiment' can be both a blessing and a curse, and has led to the rise of 'behavioural finance' study – the consideration of how easy it is to predict the behaviour of investors during different market environments. The best investors know they are predicting other investors' behaviour just as much as the performance of an individual company. Bonds are no exception to this.

Political risk

A further factor to be considered is political risk. This is particularly the case with bonds issued by companies based in developing or emerging markets, which often have less stable political and economic frameworks. In these markets political developments can throw even the best-managed organisations off-track. Investors in certain countries have to consider the risk of conflict breaking out in their own or neighbouring countries.

Valuations/other asset classes

Bonds should not be viewed in isolation, of course, and the performance of other asset classes often has an impact on the price of bonds. If other asset classes offer more attractive risk-adjusted returns, investors will reduce their exposure to bonds, and vice versa. This subsequently affects prices.

Regulations

Like any asset class, the price of a bond depends on the interaction of demand and supply. One of the biggest factors affecting demand for bonds is changing regulations, particularly those governing pension funds. In recent years there have been several modifications to pension fund and insurance regulations that have reduced institutional investors' demand for equities and increased their appetite for bonds. This has not been matched by an increase in supply, and this mismatch has been a major reason behind the sustained rise in bond prices in recent years.

Supply

The supply of bonds can also fluctuate wildly, dependent on a multitude of factors. In the government bond market, for instance, issuance is directly linked to the state of the public finances. The bigger the shortfall between government revenue and expenditure, the more bonds will have to be issued to raise the cash needed. When the public finances are in good health, as they were in the UK at the turn of the century, the government may issue fewer bonds. This creates a shortage, and so increases the price of existing bonds.

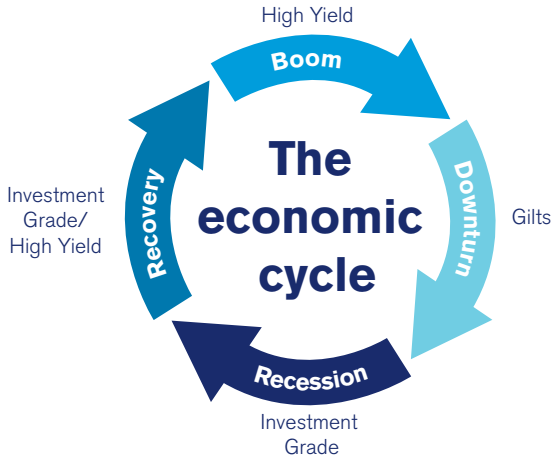
Supply and demand is sometimes difficult to get right

The key to successful bond investing? Diversification

A lot of investors think of fixed income as one homogeneous asset class, with little to differentiate the different types of bonds available, but as we've tried to explain, when you take a closer look, that's not the case.

Different types of bonds perform differently at different stages in the economic cycle. For example, as the economy slows, Gilts and sovereign bonds tend to perform better, while in a strongly-performing economy investment grade and high yield will deliver better returns. Therefore investors need to think of diversifying within their bond portfolios in order to make the best of the economic environment. If you only invest in one particular fixed income asset class, you may be disappointed with the level of returns you get, depending on the market conditions the manager has to contend with.

The chart below explains how different fixed income assets can gain in popularity at different times in the economic cycle. A well diversified fixed income portfolio is likely to contain a proportion of bonds in each main category in order to take full advantage of each market as it develops.



Understanding the fixed income economic cycle

A successful bond fund manager needs to understand the various factors that can influence the market – including whether interest rates are on an upward or downward path – and make active decisions that correspond with their views on future market directions. If they can do this, then bonds can potentially offer clients a consistent income stream with lower risk than investing in equities.

Conclusion

No investor can afford to ignore fixed income as an asset class. As well as providing a steady income stream for more cautious investors, bonds help investors to diversify their level of risk within an investment portfolio – their relative lack of correlation with other assets such as equities and property means they can offer some protection in volatile markets. More cautious investors with a shorter investment horizon should be considering their fixed income allocation as the core of their portfolio.

A well diversified portfolio of assets helps reduce risk

Investing with Henderson

Henderson Global Investors has considerable expertise in bond markets and has been managing client money successfully since 1934.

Henderson has one of the largest fixed income teams in the UK, with over 50 investment professionals. Our Fixed Income team has an average of 14 years' experience and together they manage more than £16.3 billion in fixed income assets (at 30 June 2012).

The team manages a broad range of single sector fixed income funds designed to generate consistent returns at various stages in the economic cycle, with portfolios focused on specific asset classes, such as UK Gilts, investment grade or high yield, as well as more complex 'absolute return' investment vehicles such as the **Henderson Credit Alpha Fund**. Such funds can be used to diversify into different areas of the fixed income market, with the aim to create a more rounded investment portfolio or to take advantage of clear opportunities at specific stages in the economic cycle.

As well as single sector funds, Henderson also has a number of managed fixed income solutions with the flexibility to switch their asset allocation into different areas when opportunities arise. This range includes the **Henderson Strategic Bond Fund**, which is prepared to adopt major shifts in asset allocation and utilise interest rate futures and derivatives to enhance returns, and the **Henderson Fixed Interest Monthly Income Fund**, which blends both investment grade and sub-investment grade corporate bonds with the aim to offer investors a high yield with the potential for capital growth.

For more information on our bond funds and other offerings visit **www.henderson.com**

Glossary of terms

Absolute return

Absolute return funds look to make positive returns regardless of whether the overall market has fallen or risen. An absolute return fund therefore generates returns with a degree of independence from movements within financial markets.

Absolute return is a measurement of the return of an asset over a period of time. Absolute return differs from relative return (see below) because it does not compare the fund with a benchmark, though some absolute return funds can be benchmarked against the London Interbank Offered Rate (Libor) which is the rate of interest at which a small group of banks in London are willing to lend to each other.

Alpha

Alpha is the standard measure for assessing the performance of active fund managers. It is the return in excess of a benchmark index, or "risk-free" investment, and it enables clients to work out if the level of return they receive more than makes up for the additional risk they choose to take on, i.e. risk adjusted return.

Asset allocation

Asset allocation aims to divide an investment portfolio among different asset categories, such as stocks, bonds, property and cash. How much you chose to invest in each of these asset classes can have a significant influence on the performance of the fund.

Basis points

One basis point is equal to 1/100th of 1.00% i.e. 0.01%. Therefore, 1% is equivalent to 100 basis points and 0.01% is equivalent to 1 basis point. Often abbreviated to 'bps'.

Benchmark

A benchmark enables investors to compare the performance of the fund against a relevant index. For example, a UK invested fund might have the FTSE All-Share Index as a benchmark and a stated objective to outperform the index over a certain period.

Beta

A measure of volatility that determines the risk of a security in relation to the wider market. A beta of 1.0 indicates that a fund carries the same level of risk as the market, and should therefore provide the same level of return. However a fund with a beta of 1.2 would in theory be 20% more volatile than the market, and should therefore offer investors the prospect of greater returns for the additional risk participation.

Bond

An IOU issued by a borrower, usually a government or company, who pays a specific sum of money (coupon) regularly over the life of a bond and repays the face value at maturity.

Breakeven rate

The difference between the yield on a conventional bond and an inflation-linked bond; it provides an indication of investors' inflation expectations.

Certificate of deposit (or CD)

A written certificate issued by a bank or financial institution stating that a fixed amount has been deposited with it for a fixed amount of time at a predetermined rate of interest.

Like bonds, a certificate is transferable.

Corporate bonds

Bonds issued by companies and non-government institutions.

Credit

Another name for bonds issued by entities other than governments.

Credit default swaps (CDS)

A CDS is an agreement designed to switch investment exposure between two parties. The buyer pays a periodic fee for protection against a specific event (such as an investment grade default) in return for compensation in case of default. A CDS is often used like an insurance policy, but there is no requirement to actually hold any asset, which makes it a 'derivative'.

Credit rating

Sovereign and corporate bonds can have a credit rating from one or more leading rating agencies, such as Standard & Poor's, Moody's and Fitch. The agencies assess the issuer's ability to service its interest payments and repay the principal, and assign it a rating that represents the risk of default.

Default risk

This is the probability that the bond issuer is unable to make its coupon or principal payments. Investors affected may suffer a loss of income and only a partial principal repayment.

Derivatives

A derivative is a financial instrument whose price is derived from another asset. Rather than buying or selling the asset itself, two parties enter into an agreement to exchange money, assets or some other value at a future date. Derivatives are used to increase or decrease exposure or reduce or increase levels of risk within a portfolio and are more cost-effective than purchasing the underlying assets themselves.

Diversification

The aim of diversification within an investment portfolio is to reduce your overall levels of risk. By choosing asset classes that behave in different ways you do not over-rely on one particular asset for returns. A portfolio of different kinds of investments, and in various geographical locations, will, on average, offer a more attractive risk-adjusted return than any individual investment found within the portfolio.

Duration

Duration is an indication of how sensitive a bond's price is to a change in interest rates.

Like a bond's maturity, it is measured in years; unlike maturity, however, it factors in all the cash flows received over the life of a bond (coupon and redemption payments).

1. The shorter a bond's maturity, the shorter its duration, and vice versa. Cash flows expected in the near term are more valuable than cash flows due in the distant future because an investor can be more certain of receiving them. With a short-maturity bond, a greater proportion of total cash flows are due in the near term, making it quicker for investors to recoup their original investment.

2. The higher a bond's coupon rate, the shorter its duration, and vice versa. In a similar vein, if two bonds have the same maturity, the one with the higher coupon rate will pay investors a greater proportion of total cash flows in the early years. Again, because investors recover their investment faster, the bond has a shorter duration.

As long as an investor receives some cash flow payment prior to the redemption date, the bond's duration will be shorter than its maturity. In the case of zero-coupon bonds – which, as their name implies, do not have periodic coupon payments – duration is equal to maturity because investors receive only one lump-sum payment, on the bond's redemption date.

Duration's usefulness is that it determines how sensitive a bond's price is to changing interest rates: for a 1% change in interest rates, the percentage change in a bond's price will be approximately equal to its duration. Remember that bond prices move inversely to changes in interest rates: so, if a bond's duration is 10 years and interest rates were to fall by 1%, the bond's price would rise by 10%; if interest rates were to rise by 1%, the bond's price would fall by 10%. Clearly, the higher a bond's duration, the more sensitive (or volatile) its price will be to a change in interest rates. Therefore, depending on whether interest rates are expected to rise or fall, investors would do better to focus on bonds with particular duration characteristics. If interest rates were expected to fall, investors would normally benefit the most from rising bond prices if they lengthened duration; conversely, if rates were expected to rise, they would limit the negative impact of declining prices by shortening duration.

Duration risk

The impact of an interest-rate change on a bond portfolio's value.

Fixed income

Another name for bonds – it refers broadly to assets whose income remains constant. It also covers bonds that have a variable coupon (e.g. inflation linked bonds)

Floating rate note

A bond whose interest rate varies with short-term rates. Also known as variable notes.

Gilt

A bond issued by the British government.

Hedge Fund

A fund that uses an assortment of trading techniques and financial instruments including derivatives to meet its objective. The aim is often to provide positive investment returns irrespective of the performance of financial markets. A hedge fund can take short positions, employ derivatives, use leverage and has relatively few investment restrictions.

Inflation-linked bond

A bond issued by governments or companies, whose coupon and face value are adjusted to reflect price increases. Index-linked bonds are inflation-linked bonds issued in the UK.

JGBs

An abbreviation of Japanese Government Bonds.

Leverage

Leverage is essentially borrowing money to increase your holdings or exposure. It allows a manager to increase the amount invested in the fund to more than 100% of the total fund net asset value.

Life

The length of time between a bond's issuance and maturity. Also called 'term to maturity' or just 'term'.

Long/short

A fund management strategy that involves buying certain investments ('long') and selling others ('short'), see also shorting.

Market risk

Investing in the financial market enables you to benefit from its growth potential over the medium to long-term. However, there is also a risk (market risk, also known as systemic risk) that you could lose your money if the financial market in which you have invested experiences a fall in value.

Maturity

The end of the life of a security when the principal amount must be repaid.

Nominal value

This is the value of the bond and is the amount that the borrower promises to pay at maturity. Also known as par value, face value or principal.

OATs

An abbreviation of 'Obligation Assimilable du Trésor'. These are bonds issued by the French government.

Portfolio symmetry

Fund managers can use portfolio symmetry in order to reduce risk and generate additional returns. The manager takes a short position in an asset class, while simultaneously adding a long position ensuring that the portfolio has symmetrical long/short exposure.

Shorting

A short seller looks to profit from companies whose bonds could fall in value by borrowing the bond, then selling it with the intention of buying it back at a later date, at a lower price, or by taking a short position using a derivative. Where a short position is created through physical securities – and therefore this is often done via repo in bond markets – the bond is returned to the lender at the agreed date, and the short seller makes a profit from the difference between the two prices, minus an agreed fee.

Spread

The difference in yield between two bonds, measured in basis points. When one of the bonds is a top-rated government bond, the spread represents the additional return investors are demanding to choose an asset with a higher default risk over one with virtually none.

Sophisticated UCITS III fund

A sophisticated UCITS III fund has access to a wide range of alternative asset classes, such as derivatives, secured loans, exchange traded funds and fund of funds. A non-sophisticated UCITS III employs a traditional long-only fund structure restricted to the purchase and sale of physical assets such as equities and bonds and can use derivatives only for efficient portfolio management.

Strategic bond fund

A bond portfolio that is able to take strategic investment decisions across the entire fixed income asset spectrum, and is not restricted to one particular type (e.g. investment grade or high yield). The benefit of a strategic bond portfolio is that the fund is capable of generating superior risk-adjusted returns at any point in the economic cycle.

Swap

An exchange transaction between two parties, who exchange periodic interest payments. Usually refers to exchanging floating-rate payments for fixed-rate payments.

TIPS

TIPS are 'Treasury Inflation Protected Securities' – inflation-linked bonds issued by the US government.

Total returns

The total return of an investment includes the income and capital appreciation of an asset, including interest, capital gains, dividends and distributions received over a given time period.

Unconstrained asset allocation

A fund with unconstrained asset allocation has the freedom to invest in a variety of asset classes, regions or market caps.

Uncorrelated returns

A well-diversified portfolio of investments should derive returns from a variety of uncorrelated asset classes, so that performance remains consistent despite market downturns or volatility.

Volatility

A way to measure the tendency of a fund or security to vary over time. Volatility tends to be measured by the variance or standard deviation of the price and is said to be high if the price typically changes dramatically in a short period of time.

Yield

Yield-to-maturity or redemption yield is the return of an investment held until maturity, taking into account both coupon payments and capital gains or losses. A bond's simple yield is equal to the coupon rate divided by the bond's price.

Important Information

Please read all scheme documents before investing. Before entering into an investment agreement in respect of an investment referred to in this document, you should consult your own professional and/or investment adviser. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested. Tax assumptions and reliefs depend upon an investor's particular circumstances and may change if those circumstances or the law change. If you invest through a third party provider you are advised to consult them directly as charges, performance and terms and conditions may differ materially. Nothing in this document is intended to or should be construed as advice. This document is not a recommendation to sell or purchase any investment. It does not form part of any contract for the sale or purchase of any investment. Any investment application will be made solely on the basis of the information contained in the Prospectus (including all relevant covering documents), which will contain investment restrictions. This document is intended as a summary only and potential investors must read the prospectus, and where relevant, the key investor information document before investing. Issued in the UK by Henderson Global Investors. Henderson Global Investors is the name under which Henderson Global Investors Limited (reg. no. 906355), Henderson Fund Management Limited (reg. no. 2607112), Henderson Investment Funds Limited (reg. no. 2678531), Henderson Investment Management Limited (reg. no. 1795354), Henderson Alternative Investment Advisor Limited (reg. no. 962757), Henderson Equity Partners Limited (reg. no. 2606646), Gartmore Investment Limited (reg. no. 1508030), (each incorporated and registered in England and Wales with registered office at 201 Bishopsgate, London EC2M 3AE) are authorised and regulated by the Financial Conduct Authority to provide investment products and services. Telephone calls may be recorded and monitored.

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