

A primer on Bonds

Bonds and other fixed-income instruments can play an important role in a portfolio as they may provide diversification, an element of stability and the potential for a reliable income stream.

How bonds work

A bond is simply a loan you make to a corporation, municipality, or government agency. The borrower gets the cash it needs, while you, the lender, earn interest for the term of the loan. For the use of your money, the borrower promises to pay you a specific interest rate on a regular basis for a set period of time.

This information is formally spelled out in the loan agreement with:

- Amount of the loan (principal)
- Rate of interest (coupon)
- Payment schedule

For example, if you buy a \$1,000 bond paying 5% interest annually for 20 years, you are entitled to receive \$50 every year in interest payments for the period you hold the bond.

This steady, predictable stream of interest is why bonds are called fixed-income investments. Other fixed-income investments include: Guaranteed Investment Certificates (GICs), investment contracts, mortgage-backed securities, and savings bonds.

A bond can be bought and sold in the open market, similar to a stock. When the bond matures, the borrower repays you the original purchase price of your bond. Prior to the bond's maturity, its market value will vary as interest rates in the economy rise or fall.

For example, using the same \$1,000 bond paying 5%:

- If interest rates rise to 7%, the value of your bond will be worth less because investors want new bonds paying more; therefore, your bond will depreciate, losing resale value.

- If interest rates fall to 3%, your bond becomes more valuable than those issued after yours; this means the bond has appreciated and you could sell it at a premium.

This hypothetical example is for illustration only and is not intended to reflect the return of any actual investment.

Investments do not typically grow at an even rate of return and may experience negative growth.

Maturity and duration

Maturity — the time until the loan is repaid — is a factor determining a bond's income, as well as its volatility. Bonds are categorized as:

- Short-term (usually five years or less)
- Long-term (10 years or longer)
- Intermediate-term (in between the two)

The risk of bonds varies with maturity because the possibility of gains and losses varies with the length of time interest and principal payments are exposed to market rate fluctuations. Because the value of the remaining stream of payments varies with changes in interest rates, longer maturity bonds fluctuate more than shorter maturity bonds for a given change in rates.

This fluctuation is measured by duration, a more precise calculation of the "effective life" of an investment. Compared to maturity, which only deals with the date when the principal is finally repaid, duration also reflects the amount and frequency of all payments, as well as today's price. Duration is an estimate of a bond or bond fund's sensitivity to interest rates.

Bond Yields

Credit quality is a major factor in determining a bond's stated yield. Independent rating agencies, such as Moody's Investors Service, DBRS and Standard & Poor's Corp., rate bonds according to the issuer's financial health and ability to make interest payments and repay the principal in full at maturity.

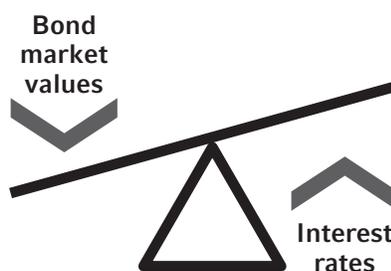
Investment grade bonds tend to have a relatively low risk of default and generally offer lower yields than below-investment-grade bonds. Issuers with lower credit ratings are perceived as more risky and must offer their bonds at a higher yields to attract investors.

Risks

Although the stock market is generally considered more volatile, bonds carry their own forms of risk. The most significant ones are interest-rate risk and credit-quality risk.

Generally, the higher the risk the larger the yield, or return, to the investor. For example, Government of Canada bonds, backed by the creditworthiness of Canada, pay lower yields than bonds issued by corporations with a less creditworthy reputation.¹ When you accept high yields and low credit quality, you risk seeing the bond issuer default on their bond obligations.

The biggest risk of a bond investment is if the issuer goes bankrupt, the loan may not get paid back at all. In bankruptcy cases, bank lenders have the first claim on any assets that the bankrupt company may have. But bondholders have a higher claim than stockholders, which is one reason bonds are generally less risky than stocks.



The inverse relationship between bond values and interest rates.

When interest rates rise, bond prices generally fall. This means that bonds — particularly longer-term bonds — are highly susceptible in economic climates with rising interest rates. If your investment portfolio is heavily weighted with bonds, you could watch your nest egg shrink significantly during some periods. If rates rise and you try to sell a bond before it matures, you will find that the bond's price on the open market has fallen below what you paid for it. You would lose some of your original investment if you sold before maturity.

Diversifying your bond portfolio

A bond mutual fund is a convenient way to invest in bonds and diversify your bond portfolio. Managed by experts who invest in many different bonds, a fund doesn't have all its money riding on one corporation or municipality, one interest rate, or one maturity.

However, there are risks associated with investing in a bond fund rather than in bonds themselves. An investor can lose money by selling units that have dipped below the purchase price. And a bond fund doesn't have a definite maturity, as a bond does. Consequently, bond fund investors are also vulnerable to such market risks as rising interest rates. In addition, bond funds charge annual management fees.

For more information on how Russell Investments can help you pursue your investment goals, please ask your advisor or visit us at russellinvestments.com/ca

¹ Credit rating agencies try to define bond issuers by their ability to pay bondholders on schedule. However, rating an issuer's creditworthiness is not an exact science and rating agencies can be wrong.

IMPORTANT INFORMATION

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