

market focus



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Investing in bonds – what are the risks?

Bonds are generally considered a safe investment. Yet there are some risks involved. This document therefore provides an overview of the main risks associated with investing in bonds.

The two biggest risks, which are the main focus of attention when selecting bonds, are interest rate and credit risk. However, other risk factors such as liquidity and foreign currency risks should not be ignored. So what do the various risks actually refer to?

Interest rate risk

When issuing a bond, the coupon rate is normally set so that the initial quoted price for the bond is roughly 100% of its par value. Consequently, the coupon defined at the start is roughly equivalent to the yield to maturity. If interest rates fall, the bond becomes more attractive because the coupon looks more favourable compared with current interest rates. Conversely, the bond becomes less attractive if interest rates rise. In short: rising interest rates result in a drop in the price of bonds while falling interest rates lead to price gains. The metric that expresses the risk of changes in interest rates is duration. The longer the remaining period to maturity and the lower the coupon is, the longer the duration. Bonds with a short maturity and high coupon are therefore exposed to a lower risk of changes in interest rates than those with a long maturity and low coupon.

Credit risk

Credit risk (also referred to as default risk or creditworthiness risk) refers to the risk that the issuer of the bond might not be able or willing to pay the coupon or redeem the bond at par value on the due date. The creditworthiness of the borrower is assessed, among others, by international rating agencies such as Standard & Poor's and Moody's. The higher the assessment of the credit risk, the higher the risk premium the investor has to be offered. The normal measure of the risk premium on bonds is the credit spread. A deterioration in credit quality during the term of the bond leads to a drop in its price, while an improvement leads to a price rise. The worse the creditworthiness of the borrower, the more likely it is that the credit quality will alter over time.

Event risk

Event risk is the risk of unforeseen events, for example, natural disasters or industrial catastrophes. It also includes major corporate events such as mergers and acquisitions. These cannot normally be controlled by the issuer or the market but depending on their extent they can have a major impact on the issuer's financial strength and thus on the bond price.

Foreign currency risk

There is always a foreign currency risk when a bond is denominated in a currency that is not the investor's reference currency. As well as being exposed to the possibility that the bond might gain or lose value, investors bear the risk that the investment currency could rise or fall against the reference currency. Investors are often enticed into investing in foreign currencies by higher coupons. However, fluctuations in exchange rates are generally higher than the changes in the bond price. Therefore, the additional income generated by a higher coupon can easily be eroded.

Liquidity risk

Liquidity risk is the risk that there might suddenly be little or no trading in a bond. In such cases, the bond either cannot be sold or can only be sold at a big discount. Small-scale bond issues tend to be worse affected by liquidity risk than large issues. The less a bond is traded after issue, the greater the difference normally is between the bid and ask prices (also known as the bid-ask spread).

Prospectus risk

Bonds are not standardized securities. Their individual attributes are outlined in the prospectus. Alongside details of the issuer, the prospectus contains information on, for example, whether the debt is senior or junior, any call and put modalities and further details of the issuer's rights and obligations. Failure to pay attention to relevant information of this type in the prospectus can result in incorrect assessment and price declines.

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