

Thought Piece

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Factors that influence the price of fixed rate bonds

Bonds of higher quality such as investment grade issues are likely to give investors comfort as to the safety of the capital invested. The following explores what affects the market trading price of bonds, and how to make bond investments that are most suitable for your investment objectives.

Why does this matter to me?

Bonds, especially those with a fixed coupon rate, can change in price through the bond's term (or years to maturity). The only date upon which the capital value is known (\$100) with certainty (barring default) is the bond's maturity date.

What are fixed rate bonds and what changes their price?

For fixed rate bonds, the "coupon", or regular interest payment, is fixed for the term of the bond. The bond's market price and its yield to maturity (the overall return if the bond is held for the full term) will be driven by:

- (i) changes in interest rates that the RBA sets; and
- (ii) the market's expectation of where interest rates move in the future.

Myriad factors will affect what action, if any, the RBA takes at its rate setting meetings, which are held on the first Tuesday in every month except January. (This will change in 2024 to a more USA Fed style program of just eight meetings, spaced by around six weeks.) The most important data for the RBA are the consumer price inflation data and the state of the labour market; but overseas factors, especially those affecting the USA and our biggest trading partners in Asia are very important too.

When an investor buys a fixed-rate bond, they will receive contractually agreed fixed coupon (interest) payments usually semi-annually, until the bond matures. If the investor holds the fixed rate bond until maturity, price moves are irrelevant, and they will receive the full face-value at redemption. That face value is always \$100.

However, the bond's trading price at any one time can fluctuate. If the investor wishes to sell the bond before maturity this price may be above or below \$100: if rates are rising more than anticipated, the price of a fixed rate bond will decline and when rates are falling more than anticipated, the price of a fixed rate bond will rise. Currently, many fixed rate bonds with lower coupons that were issued in the past few years are trading at a significant discount to their face value.

The below diagram illustrates how a Challenger 2027 bond's returns happen over its term including the payments an investor will receive in coupons and capital return.
[remember to insert diagram!]

How can I reduce price volatility in my investment portfolio due to bond price fluctuation?

In any portfolio, diversification of investments is key to reducing risk. When investing in bonds, the investor should consider the bond issuer (the company behind the bond) and other factors such as the bond's term to maturity. The following will help to reduce price volatility due to bonds in an investor's portfolio.

What can I do?

Include shorter-term bonds in the portfolio - For fixed rate bonds, the shorter the time to maturity, the more stable the bond's price will be.

Example of two fixed rate bonds that suit this strategy - Macquarie 6.082 27s that pay a fixed coupon of 6.082% and are currently yielding ~5.5% to their call date on 7 June 2027 and the Challenger 7.186 27s that pay a fixed coupon of 7.186% and are currently yielding 6% to their call date on 16 September 2027.

Include bonds with a floating rate – Many bond issuers issuing fixed rate bonds also issue floating rate bonds. These bond's coupons are usually paid quarterly and rise and fall with changes in the market interest rates dictated by the RBA. Their return will be based on what is known as the 90-day bank bill rate, BBSW. As the coupon rates of these bonds change with interest rates, the bond's market trading price/100 is usually more stable than that of a similar fixed rate bond.

Example of two floating rate notes that suit this strategy - Liberty 28s that have a current coupon of 7.9% and are currently yielding 8% to their maturity date on 16 March 2028 and Pacific National 27s that pay a current coupon of 7% and are currently yielding 7% to their maturity date on 12 May 2027.

Contact Us

If you need assistance or would like to speak with one of our IAM Capital Market specialists, don't hesitate to contact us. Our operating hours are 9:00am to 5:00pm weekdays (AEDT).

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