

Fixed Interest Investments

What are Fixed Interest Investments?

Fixed interest investments are debt instruments. Like any form of debt, there are two components to repayment or return: **interest** and **principal (or par value)**. That is, fixed interest instruments provide a known income for a set period of time (interest payments) and, if held to maturity, a return of the par value of the instrument (the principal). It should be noted that if you buy fixed interest investments on the secondary market rather than directly from the issuer, you may pay more than par value (a **premium**) or less (a **discount**). If you pay a premium or discount on the secondary market, at maturity you will receive the original principal, the par value, not the amount that *you* paid.

Examples of fixed interest investments include:

- Government bonds (you are lending the Government money)
- Semi-government bonds (you are loaning a government-backed enterprise money)
- Corporate bonds or debentures (you are loaning a company (i.e non government) money)

Interest on fixed interest instruments is payable monthly, quarterly, half yearly or yearly. Terms of investment can range from 1 to 10 years.

The **yield to maturity** may differ from the fixed rate of interest repayments. For example, suppose a ten-year bond is issued with a 7% interest rate which is called the coupon rate, at a \$10,000 par value. Now, if due to lower inflation and a weak economic outlook ten-year market interest rates fall to 6%, many people will find the 7% interest repayment rate very attractive. Market forces being what they are, demand for that bond will drive the price up beyond its face value. As with any investment, the more you pay, the lower the yield becomes. In this example, it would be expected that the price would be bid up until the *yield to maturity* is around 6%. While the holder of the bond still receives \$700 *per annum* for each \$10,000 of par value, since a premium price has been paid on the secondary market, the *yield to maturity* will fall below 7%.

What are the risks?

- Credit risk

The ability of the debtor to make payment on interest and principal according to schedule may not be completely certain. While a government has the ability to use its taxing authority to generate the cash to meet payments, private sector companies rely on operating revenues or provisions in the balance sheet to meet loan re-payments. If business revenues slow, companies may *default* on payments. Since generally the credit risk of governments is lower than private companies, government bonds typically trade at a lower yield. In other words, investors buying

corporate bonds would typically demand higher compensation for credit risk in the form of a higher yield relative to government bonds of the same maturity.

- **Re-investment risk**

Suppose you have happily adopted a “buy and hold” strategy because you were fortunate enough to buy new issues at par offering a 15% fixed rate. Why change when current interest rates are a mere 6%? The problem is, “buy and hold” only protects until the bonds mature. Re-investment and event risks can be severe: suppose that when it comes time for you to reinvest at maturity, bond prices have reached an all-time high. If you reinvest at this time, you may be locking-in record-low yields and the prospect of seeing declines in the dollar value of your portfolio. Active management of a bond portfolio can be used to manage re-investment risk. For this reason, investing in fixed interest funds, or bond funds as they are often called, may be beneficial.

- **Interest rate risk**

Hold on, the interest rate is *fixed*, so what’s the risk? It is true that your schedule of interest repayments is fixed. Yet market interest rates, the yield that a new investor would receive, fluctuate minute by minute. If general market interest rates increase, you can experience a decline in the dollar value of a bond portfolio. So, if you monitor the current market value of a fixed interest portfolio, the dollar value will decrease as interest rates increase. Conversely, if interest rates fall, you will enjoy a price appreciation on bonds. Note that this refers to an investor holding a *portfolio* of bonds, not a single fixed interest security which is held until maturity.

Taxation and Social Security

Social Security

Fixed interest investments are treated as financial investments and they are counted as assets under the assets test. Deemed rates of return are attributed to financial investments under the income test. Ideally, the actual income from the fixed interest investments should at least match the deemed rates of interest where possible so that total income can be maximised.

Taxation

The interest payments from fixed interest securities are fully taxable at marginal tax rates, as is any ‘profit’ you make from changes in the value of the investment on sale or maturity.

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