



DEMYSTIFYING FIXED INCOME

BUILD A STABLE INVESTMENT
PORTFOLIO

INTRODUCTION

The financial landscape is shifting, making the understanding of Fixed Income a critical skill. Recent headlines about defaults, buybacks and rising interest rates, coupled with mounting government debt, paint a clear picture. This comprehensive guide act as investors' road map to navigating this essential asset class while uncovering its benefits and risks, thus enabling strategic investors to make informed investment decisions and build a stable portfolio that aligns with their risk and return objectives.

What Is Fixed Income?

Imagine lending money to a reliable friend who pays you back with regular interest. Fixed Income investments work in a similar manner. An investor lends money to governments or corporations through bonds, certificates of deposit or money market funds. In return, one earns regular interest payments and gets the initial investment back with final interest at maturity or receives a stream of payments that gradually return the principal along with interest or gets both the principal and all the interest in a lump sum at maturity.



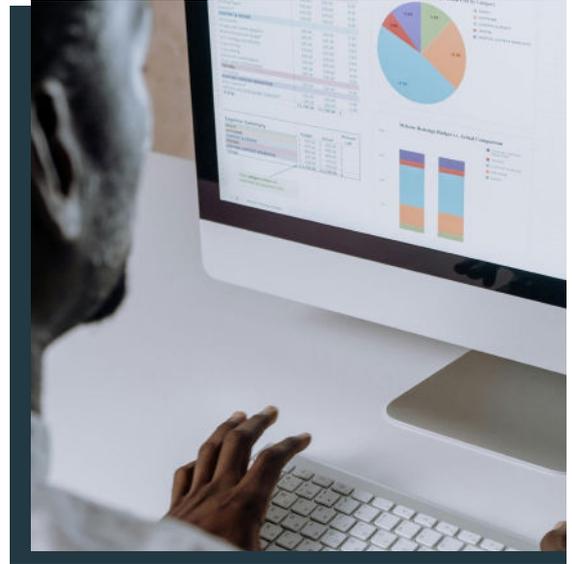
UNDERSTANDING THE BUILDING BLOCKS

Issuer: The entity that issues the bond to raise funds. The issuer is responsible for making interest payments to bondholders and repaying the principal upon maturity.

Maturity: The date on which the bond's principal amount becomes due and payable to the bondholder. Bonds can have short-term, medium-term or long-term maturities.

Par Value: The par value is the nominal value of the bond, typically set at issuance. It represents the amount that the issuer promises to repay to the bondholder at maturity. Bonds are usually issued at par, but they may trade at a premium (above par) or at a discount (below par) value.

Coupon Rate: The fixed or variable interest rate that the issuer agrees to pay to bondholders periodically, typically semiannually or annually as a percentage of the bond's par value. The coupon rate determines the amount of interest income that bondholders receive.



Why Invest in Fixed Income?

Fixed Income investments offer several benefits to investors, including:

Regular Income: Fixed Income investments provide a steady stream of income in the form of interest payments, which can be an attractive feature for investors seeking to generate regular cash flow.

Capital Preservation: Fixed Income investments are generally considered to be less risky than stocks, as they offer a contractual right to receive principal back at maturity.

Diversification: Fixed Income investments help to diversify an investment portfolio, which can reduce overall portfolio risk.

Hedging against Inflation: Some Fixed Income securities, such as Treasury Inflation-Protected Securities (TIPS), can help to protect against inflation by adjusting the principal amount based on changes in the Consumer Price Index (CPI).

Interest Rate Volatility Protection: By strategically selecting bonds with maturities and coupon payments similar to a desired fixed interest swap (a financial contract where two parties exchange interest rate payments, one fixed and one floating), investors can replicate the swap's behavior and potentially mitigate the risks associated with fluctuating interest rates.

Types of Fixed Income

The world of Fixed Income offers a variety of products with different features and investment options. This allows one to tailor their investments towards specific goals. Let's explore some of the most common Fixed Income products.



Treasury bills: Short-term debt securities issued by governments to raise funds. They typically mature in less than one year and are considered one of the safest investments because they are backed by the government's credit.

Treasury Notes: Medium-term debt securities issued by governments, usually with maturities ranging from two to ten years. They pay interest every six months and are considered relatively safe investments.

Treasury Bonds: Long-term debt securities issued by governments with maturities typically ranging from ten to thirty years. They pay interest semiannually and are considered low-risk investments because they are backed by the government's credit.

Infrastructure Bonds: Bonds issued by governments or private entities to finance infrastructure projects such as roads, bridges, airports and utilities. These bonds help fund the construction and maintenance of essential infrastructure.

Corporate Bonds: Debt securities issued by corporations to raise capital for various purposes, such as expansion, acquisitions or operations. Investors receive periodic interest payments and the return of principal upon maturity.

Certificate of Deposits (CDs): Time deposits offered by banks or credit unions with fixed terms and fixed interest rates. They typically offer higher interest rates than regular savings accounts but require the depositor to keep the funds on deposit for a specified period.

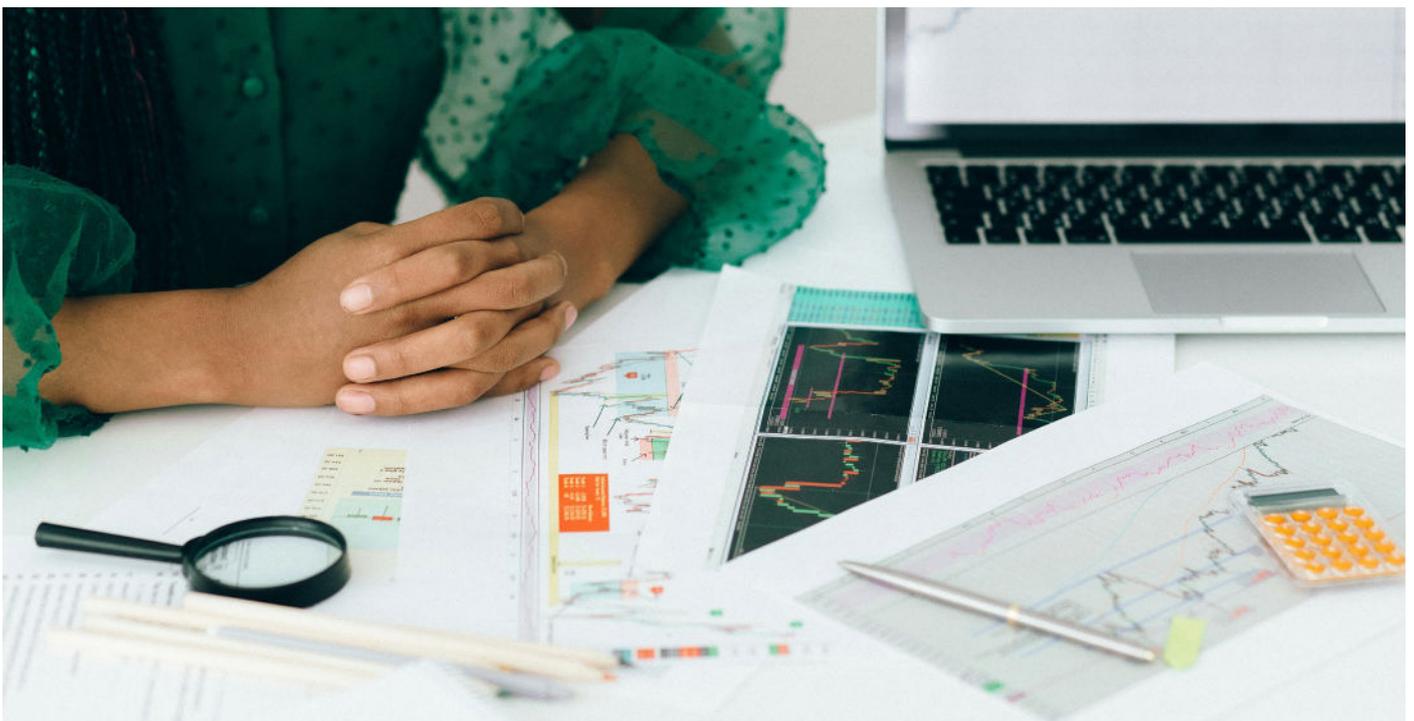
Supranational Bonds: Bonds issued by international organizations such as the IMF, World Bank or regional development banks. These bonds are used to raise funds for global development projects and are backed by the credit of member countries. They play a crucial role in financing initiatives aimed at promoting economic growth and stability worldwide.

Money Market Funds: Mutual funds that invest in short-term, low-risk securities such as Treasury bills, commercial paper and certificates of deposit and also Fixed Income funds that only invest in Fixed Income securities. They offer investors a relatively safe place to park cash while earning a modest return.

Asset-Backed Securities (ABS): Securities backed by pools of assets such as mortgages, auto loans or credit card receivables. These securities offer investors exposure to diversified pools of underlying assets and are structured to pay interest and principal based on the cash flows generated by the underlying assets. ABS can vary widely in terms of risk and return depending on the quality of the underlying assets and the structure of the security.

Unlocking True Value: Essential Fixed-Income Valuation Methods

While fixed-income offers a reliable stream of income, maximizing returns requires looking beyond just face value and coupon rates. Mastering valuation methods equips one to make informed investment decisions by allowing one to compare different bonds and identify those offering the best returns relative to their risk. Common valuation methods include:



Yield-to-Maturity (YTM): This popular method calculates the internal rate of return (IRR) one would earn if they hold the bond until maturity, assuming all coupon payments are reinvested at a specific rate.

Discounted Cash Flow (DCF): Similar to YTM, DCF uses discounted cash flow analysis. However, it offers more flexibility by allowing for different discount rates to reflect the varying risk profiles of different bonds.

Market Valuation: This method leverages the current market prices of similar bonds with comparable terms to estimate the fair value of the security one is considering.

Factors to Consider Before Investing in Fixed Income

Shape of the yield curve: Imagine the yield curve as a road map, guiding one to potential returns based on bond maturities. An upward slope presents the opportunity to “ride the curve,” where an investor invests in bonds with longer maturities than their investment horizon, resulting in higher returns. However, a flat curve suggests caution, as it might signal uncertain economic times and an inverted curve is a strong warning sign of a potential economic slowdown.

Maturity Alignment: Matching one’s investment horizon with bond maturity is paramount. Investing in bonds maturing before one’s investment horizon goal might leave one vulnerable to reinvestment risk. Conversely, holding bonds maturing beyond one’s investment horizon can result in lower returns if interest rates rise.

Fiscal Policy: Understanding the government’s fiscal stance is critical. Expansionary policies often lead to higher borrowing and potentially rising interest rates, impacting bond prices.

Monetary Policy: Central banks play a key role in setting interest rates, directly impacting bond prices. Tightening monetary policy typically leads to higher interest rates, applying downward pressure on existing bond prices. However, new bonds issued in this environment offer higher interest rates, potentially generating higher returns for investors who buy them.

Creditworthiness: Assessing a bond’s credit rating helps gauge its default risk. Bonds with higher ratings offer lower returns but greater stability, while lower-rated bonds potentially offer higher returns but carry increased risk.

Bond Options: Some bonds come with embedded options, giving one the flexibility to convert them into shares under certain conditions. This can be a valuable tool for strategic investors seeking additional upside potential.

Potential GDP Projection: If economic growth is expected to be high, bond prices might decline due to potential future interest rate hikes



CONCLUSION



Amidst the ever-shifting tides of the financial markets, Fixed Income investments stand as a reliable compass. By understanding their features, types, returns and key considerations, an investor is empowered to navigate potential uncertainties and choose options that align with their goals. Fixed Income offers lower volatility and stable income. Notably, a prudent Fixed Income strategy is key in building a secure financial future.

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