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MONEY WISE

WHY WOULD ANYONE INVEST IN BONDS?

The word 'bond' has a number of meanings in the financial world. The bonds I would like to discuss today however are fundamentally securities issued by governments to raise funds to support investment, spending, or even to repay existing debts. Raising money this way avoids the pain of raising taxes. The bonds are generally for a fixed term and pay a guaranteed rate of interest, usually half-yearly. At the end of the term the capital is repaid in full.

US Treasuries considered the safest

Perhaps I should start by reiterating that there is risk in every investment. Even failing to invest is risky, since inflation will erode the purchasing value of cash over time or even wipe it out overnight!

However, US Government Bonds, or Treasuries, are considered one of the safest investments in the world. So much so that both the Chinese and Japanese governments have each bought over $1 trillion of them. What kind of returns are they getting? 30-year bonds are currently paying 3.1% per annum; 10-year bonds are yielding only 1.9%%.

Why is there such faith in Treasuries? Basically because they are extremely unlikely to default. It is not impossible however, and they could come to brink of default in a few months' time unless politicians agree to raise the debt ceiling yet again. But raise it they will as a US default on its debt would destroy US Treasuries' reputation as a safe haven and would cause havoc in global financial markets. At the end of the day, any government can meet its debt obligations by simply printing money. The exception is the Eurozone, where individual countries cannot print money as this is the prerogative of the European Central Bank. This is why they have to offer rates of return that reflect the risk of their perceived ability to honour the debt and why rates are rock bottom in Germany and have been sky high in weaker countries.

What about Indonesian bonds?

Currently the return on Indonesian bonds is just over 5%. In 2008 it reached an all-time high of 20.8% at the height of the global financial crisis. Had you bought bonds at the time you would still be enjoying that high rate of interest. Or you could have lost heavily if the crisis turned out badly for Indonesia.

So at over 5% wouldn't it be better to buy Indonesian bonds as opposed to US Treasury bonds offering only 1.8%? Well it could be, except that in 2012 the Rupiah fell by 6% against the US Dollar so you would have been worse off at the end of the year in USD terms despite the higher interest rate, as you would also have been with a bank deposit. On the other hand, had you bought US Treasury bonds the previous year you would have been worse off in Rupiah terms as not only was the Rupiah offering a higher return it also strengthened against the US Dollar. What will happen in 2013 is anybody's guess and this leads us to the other factors that must be considered when investing in bonds.

What are the risks?

There are four main risks with government bonds: Currency risk, political risk, inflation risk and interest rate risk.

We have already seen above how currency risk can affect the real return. As for political risk, any government can interfere in or manipulate the financial markets to its own benefit and the detriment of investors. Such interference usually backfires as it will discredit the reputation of the country concerned and make it difficult to raise credit in the future.

Inflation is a big risk. Right now, the interest rates being offered by the US and several other 'strong' economies are lower than their respective rates of inflation so the real return investors are getting from bonds is negative. In other words, when you cash in your bond even with the interest you have received, the cash you now have will buy less that it would have bought when you invested it.

The final risk is that of interest rates. Should prevailing interest rates rise, the capital value of your bond will fall, meaning it is worth less on the market than you paid for it should you want to sell it on the open market prior to its maturity.

So why on earth buy government bonds?

The reason is very simple. By and large they are very safe and guaranteed by the country of issue. They may not offer the same returns as stocks (the S&P 500 rose 13% last year), but neither will they tumble like stocks as the S&P did by 37% in 2008. Pension funds cannot afford to risk everything in stocks to produce growth. Such strategies caused havoc to many funds in 2008. To ensure liquidity and guarantee their ability to pay pensions when due they have to hold a major portion of their funds in government bonds. It is not their concern if the purchasing value falls. Their concern is that they have the cash to meet their obligations.

For the same reason, the private investor should consider bonds as an integral part of a balanced portfolio, particularly the closer one is to retirement.

But we have considered only government bonds so far. There is a much wider universe of bonds that space does not permit us to explore at this time.

Colin Bloodworth, director of PPI Indonesia, has spent over 20 years in Indonesia. If you have any questions on this or a related subject you can contact the writer at indonesia@ppi-advisory.com