Lincoln Private
Investment Office

London

Fixed Income

"Debt is one person's liability, but another person's asset." Paul Krugman, American Economist

The global fixed income market has tripled in size in the past 15 years, now exceeding US$100 trillion and is larger than the size of the global equity market, which is currently around $69 trillion. The fixed income asset class (also known as bonds) is often neglected by investors, with many focusing on potential returns offered by equities. But bonds can play a crucial role in balancing investment portfolios and producing income as well as potential gains. They are generally viewed by investors as the safest component of a portfolio.

A brief history of bonds

References to bonds dating as far back as 2400 B.C. have been discovered by archaeologists. One example was a stone tablet discovered in what is modern day Iraq, but was at the time Nippur in Mesopotamia. The tablet was impressed with the names of 4 witnesses and guaranteed the payment of grain (which was a currency of the time) by the principal.

It wasn't until the 13th century that what we might recognise as government bonds were recorded. At the time, Venice was one of the most important and powerful cities in the world and began issuing government bonds to fund communal needs, defence and wars. As this bond market evolved, Venetians began to trade government securities in a secondary market.

But what exactly is a bond?

A bond represents a loan made by an investor to a borrower. It acts as a contractual promise by the issuer (the borrower) to repay the investor (or holder) the original sum at a future date. In addition, the issuer will typically pay the holder a variable or fixed interest payment during the term of the bond. As is often the case in finance, various terms are used to essentially mean the same thing; fixed income, fixed interest, debt and treasuries are all terms that are used to describe this asset class.

Who can issue a bond?

In financial markets, bonds are issued by governments, companies and supranational entities in order to borrow money.

Bond issuers are typically given a rating indicating their risk profile, or ability to repay the loan, in much the same way as an individual has a credit score. There are a number of agencies that provide ratings for bond issuers; some of the most well recognised use a letter-based ratings system. An issuer with an 'AAA' rating is judged to be the most secure, so as a result, can attract a buyer for their bonds even if they are offering a low rate of interest. An issuer with a lower rating (for example BBB) would need to offer a higher rate of interest on their bond to compensate the buyer for the perceived higher risk of them not being able to repay the bond at maturity.

Governments issue bonds to finance their budgets; for example the Bank of England issued the first ever UK government bond to fund a war against France in 1693. In the UK, government bonds are known as 'Gilts' as they were originally issued on paper with gilded edges. Companies issue bonds to fund a range of activities, such as day to day expenditure, capital investment, or mergers and acquisitions.

Trading and pricing of bonds

Once issued, bonds can be bought and sold in the market and their price fluctuates in a similar way to equities. The price that a bond trades at is driven by a variety of market factors that affect how valuable the terms of the specific bond are to the investor at any given time.

This document has been prepared and distributed for information by Lincoln Private Investment Office LLP ("LPIO") and is a marketing communication. LPIO is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute an offer by LPIO to enter into a contract/agreement, nor is it a solicitation to buy or sell any investment. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.

The table below summarises some the main factors determining bond prices:

Prevailing Interest Rates	Credit Rating	Supply/Demand	Inflation
Bond prices typically have an inverse relationship with interest rates. This means that as central bank interest rates fall, the price of a bond will increase, and vice versa.	If an issuer of a bond gets into financial difficulty, their ability to repay the debt is reduced, resulting in a fall in the value of their bonds.	Over time, the demand for bonds from investors varies as does supply in the market. Both of these factors drive prices on an ongoing basis.	Inflationary pressure is an increase in the cost of goods and services over time. High inflation can have a negative impact on the price of bonds as it reduces the real value of the future repayment of capital.

Types of Bonds

There are a number of different types of bonds in the market. Below illustrates some of the better-known types of bonds available:

Fixed or Variable Bonds
- Most bonds pay interest, or a 'coupon' on a regular basis.
- A fixed rate bond is when the interest payments are fixed at a predetermined level for the life of the bond.
- Variable rate bonds pay interest that is linked to a recognised reference rate such as LIBOR or bank base rates. These rates fluctuate over time.

Inflation Linked Bonds
- These bonds are designed to protect investors' return from the impact of inflation.
- The interest payments and principal capital amount repaid at maturity are uplifted by an official measure of inflation.
- In the UK, government inflation linked bonds are currently linked to the Retail Price Index (RPI), however the government has announced that they will move to the more commonly used Consumer Price Index (CPI) over the next few years.

Convertible Bonds
- A bond that provides a flexible form of financing for companies – it is a hybrid security.
- It has the interest payment and redemption features of a bond but can be converted to a share in the company if certain conditions are met.
- They can provide an asymmetric benefit, where you have the potential to receive equity-like performance on the upside, whilst having the protection of fixed income on the downside.

Bond funds

A bond fund pools together capital from investors to acquire a large number of different bonds, with a specialist fund manager making investment decisions. When investing in bonds it is particularly important to access the expertise of a professional manager because, unlike equities (where each share of a company is identical), a company can issue multiple bonds, each with its own individual terms and conditions, making it essential to understand the characteristics of the bond being acquired.

This document has been prepared and distributed for information by Lincoln Private Investment Office LLP ("LPIO") and is a marketing communication. LPIO is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute an offer by LPIO to enter into a contract/agreement, nor is it a solicitation to buy or sell any investment. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.

Lincoln Private
Investment Office

London

Bonds in a diversified portfolio

In a portfolio, bonds are traditionally considered lower risk than equities due to the steady stream of income from interest accruals and fixed repayment date. In times of uncertainty, investors may sell riskier equities and buy bonds, pushing up their prices. Therefore, gains on the value of bonds in a portfolio can offset at least a proportion of losses on equities.

This diversification effect is a key component of how a portfolio is constructed to meet each individual's investment objectives and means that bonds are a very important part of an investment strategy.

However, at different times in the economic cycle bonds can become over or under priced. At Lincoln, we believe that during certain periods it is important to take an unconventional approach to the bond component of our portfolios in order to maximise returns and minimise risks of this asset class for the benefit of our clients.

Lincoln Private Investment Office

This document has been prepared and distributed for information by Lincoln Private Investment Office LLP ("LPIO") and is a marketing communication. LPIO is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute an offer by LPIO to enter into a contract/agreement, nor is it a solicitation to buy or sell any investment. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.