2. Bonds / Debentures / Securitised Notes

Definition
Bonds (= debentures, notes) are securities that obligate the issuer (= debtor) to pay the bondholder (= creditor, buyer) interest on the capital invested and to repay the principal amount according to the bond terms. Besides such bonds in the strict sense of the term, there are also debentures that differ significantly from the above-mentioned characteristics and the description given below. We refer the reader in particular to the debentures described in the “Structured Products” section. Especially in that area, it is not the designation as a bond or debenture that is decisive for the product-specific risks but rather the specific structure of the product.

Return
The bond yield is composed of the interest on the capital and any difference between the purchase price and the price achieved upon sale/redemption of the bond.

Consequently, the return can only be determined in advance if the bond is held until maturity. With variable interest rates, the return cannot be specified in advance. For the sake of comparison, an annual yield (based on the assumption of bullet repayment) is calculated in line with international standards. Bond yields which are significantly above the generally customary level should always be questioned, with an increased credit risk being a possible reason.

The price achieved when selling a bond prior to redemption (market price) is not known in advance. Consequently, the return may be higher or lower than the yield calculated initially. In addition, transaction costs, if any, must be deducted from the overall return

Credit risk
There is always the risk that the debtor is unable to pay all or part of his obligations, e.g. in the case of the debtor's insolvency. The credit standing of the debtor must therefore be considered in an investment decision.
Credit ratings (assessment of the creditworthiness of organisations) issued by independent rating agencies provide some guidance in this respect. The highest creditworthiness is "AAA" (e.g. for Austrian government bonds). In the case of low ratings (e.g. "B" or "C"), the risk of default (credit risk) is higher but by way of compensation the instruments generally pay a higher interest rate (risk premium). Investments with a rating comparable to BBB or higher are generally referred to as “investment grade”.

Price risk
If a bond is kept until maturity, the investor will receive the redemption price as stated in the bond terms. Please note the risk of early calling-in by the issuer, to the extent permitted by the terms and conditions of the issue.

If a bond is sold prior to maturity, the investor will receive the current market price This price is regulated by supply and demand, which is also subject to the current interest rate level. For instance, the price of fixed-rate securities will fall if the interest on bonds with comparable maturities rises. Conversely, bonds will gain in value if the interest on bonds with comparable maturities falls.

A change in the issuer's creditworthiness may also affect the market price of a bond..

In the case of variable-interest bonds whose interest rate is indexed to the capital market rates, the risk of the interest being or becoming flat is considerably higher than with bonds whose interest rate depends on the money market rates.

The degree of change in the price of a bond in response to a change in the interest level is described by the indicator “duration”. The duration depends on the bond’s residual time to maturity. The bigger the duration, the greater the impact of changes of the general interest rate on the price, whether in a positive or negative direction.

Liquidity risk
The tradability of bonds depends on several factors, e.g. issuing volume, remaining time to maturity, stock market rules and market conditions. Bonds which are difficult to sell or cannot be sold at all must be held until maturity.

Bond trading
Bonds are traded on a stock exchange or over-the-counter. Your bank will quote buying and selling rates for certain bonds upon request.
Anleihen werden über eine Börse. There is no entitlement to negotiability, however.

In the case of bonds that are also traded on the stock market, the prices formed on the exchange may differ considerably from the off-the-market quotations. The risk of weak trading may be restricted by adding a limit on the order.

Some special bonds

<u>Supplementary capital bonds</u>
These are special subordinated bonds issued by Austrian banks. Interest payment can only be made if the bank has posted sufficient net profit for the year (before movement of reserves). Repayment of the capital prior to liquidation is subject to prorated deduction of the net loss accruing throughout the term of the supplementary capital bond.

<u>Subordinated bank bonds</u>
In case of the debtor's liquidation or insolvency, the investor will receive money only after all other, non-subordinated liabilities of the bond debtor have been settled. It is not possible to offset the claims to repayment arising out of the subordinated bond against the bond issuer’s claims.

Your customer adviser will be pleased to inform you about further special bond types such as bonds with warrants, convertible bonds, zero-coupon bonds, etc.