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Bonds? ...Really? Why?

The Bond Market is huge, considerably larger than the Stock Market. Do you wonder why?

Things I have learned listening to Robin
by Henry Pole, Guest Writer

If I asked you how much a stock in your portfolio is going to make in the next year, you'd have a hard time answering. Maybe you'd tell me how much you already made, or the trajectory of the market. But, with equity investments, it's almost impossible to know the future. Yet, if I asked you how much your bond would make in the next year, you'd be able to give me an exact figure. One asset can tell you how much you'll make, the other one simply can't.

Despite this, there is a lot of confusion about bonds. They're often seen as a boring investment, low yield and high patience. You might, quite reasonably, dismiss them as just that. However, bonds are assets whose benefits can outshine higher risk investments.



You may be familiar with interest rates if you've ever, for instance, taken out a mortgage. When you take out a loan, the interest rate determines how much you pay.

This dynamic flips when you buy a bond. A bond is essentially a loan that you are giving to a company or government. They borrow money from *you* and, over the duration of the bond, interest accumulates and pays out regularly to you.

In Canada, we have a type of asset called a Guaranteed Investment Certificate (GIC). You might already be familiar with how they work. A bond functions similarly, however it has the additional ability to be bought and sold in the resale market. Most bonds are not bought brand new but are traded multiple times before they mature.

Why would you want to sell a perfectly good, interest-accumulating bond? Well, maybe you don't want to. But isn't it nice to have the option?

insights

*An investment bulletin prepared by
Robin Kingsmill and*

The Kingsmill
Wealth Management Team

BMO / Nesbitt Burns

Robin Kingsmill
B.Sc., CIM®
Sr. Investment Advisor
Sr. Portfolio Manager
Robin.Kingsmill@nbpcd.com
905 897 5212

Susan Tapetis
B.A., CIM®, QAFP® Sr.
Investment Associate
Susan.Tapetis@nbpcd.com
905 897 5227

Kaitlin Delahunt B.A. Bus Admin
Business Associate
Kaitlin.Delahunt@nbpcd.com
905 897 1204

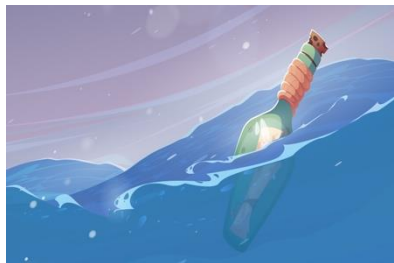
BMO Nesbitt Burns Private Wealth
360 Oakville Place Drive 2nd Floor
Oakville, Ontario L6H 6K3

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Kingsmill
Wealth Management Team
BMO Nesbitt Burns

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Every bond is a contract which gives the holder specific information about maturity, about the issuer but most importantly about the coupon (what it pays and when). This coupon is written on the day the bond is issued and, no matter how the bond market fluctuates externally, the coupon will never change. It will have the same interest rate as the day it was issued.



Like a Message in a Bottle. If we were to take a piece of paper, write something on the inside, roll it up into a bottle and push it out to sea - what happens to it? From the outside, it looks like it's changing all the time - bobbing up and down on the tide, always raising and lowering. The current might toss the bottle around on its way to you, but if you were to fish out the bottle and open it, you'd find that the message inside never changed.

Much the same way, the bond itself changes market value every time the interest rates change - which is always.

The coupon, which was set on the day it was first issued, never changes. The two values (external and internal / Coupon and Market Value) are not bound together.

When it comes to the bond market, a different date is a different rate. As interest rates change, so too does the Market Value of the bond. Yet, it should be understood that this impacts the price of the bond, not the bond itself. No matter how high or low the bottle moves, the message remains untouched. Interest accumulates daily and pays out twice a year.

Compare this to the stock market, where there are no guarantees and the constant fluctuations make predictions difficult. With a stock, you never know what you're going to get - it could be doubled in value by the end of the year, or worth less than when you started. With a bond, the outcome is already contracted.

Clearly, the differences of a Bond: both the reliable cash flow, and the Market Value opportunities offer the wise investor a measure of control when the subject is Portfolio management.

Bonds! Boring? Or Bonds! Contracted and Productive. Your Message in a Bottle! Can you see why they can be an important factor in your investment strategy?

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