Bond funds

Key questions

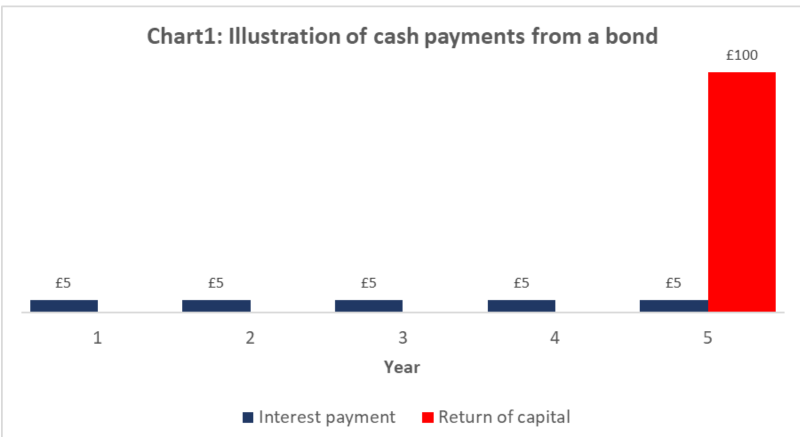
June 2022

Bond funds have experienced negative returns in 2022, much larger than in recent years.[1] In this article, we explain what bonds are, why bond funds have had negative returns and what the future might hold.

1. What are bonds?

Bonds are issued by governments, including the UK government, and companies to borrow money. Like a loan, the government or company will pay the buyer of a bond an interest payment each year and then pay back the amount or capital borrowed at the end of the term of the bond.

Chart 1 below illustrates these cash payments for a bond that borrows capital of £100 for five years, paying an interest rate of 5% each year, and then pays back the £100 after five years.



Source: Santander Asset Management UK, June 2022.

The term of the bond can vary from a few years to decades. However, the buyer of a bond does not need to keep it that long, they can sell it before the end of its term if they wish to.

2. Why are bonds considered low risk?

The main reasons why bonds are thought of as low risk are:

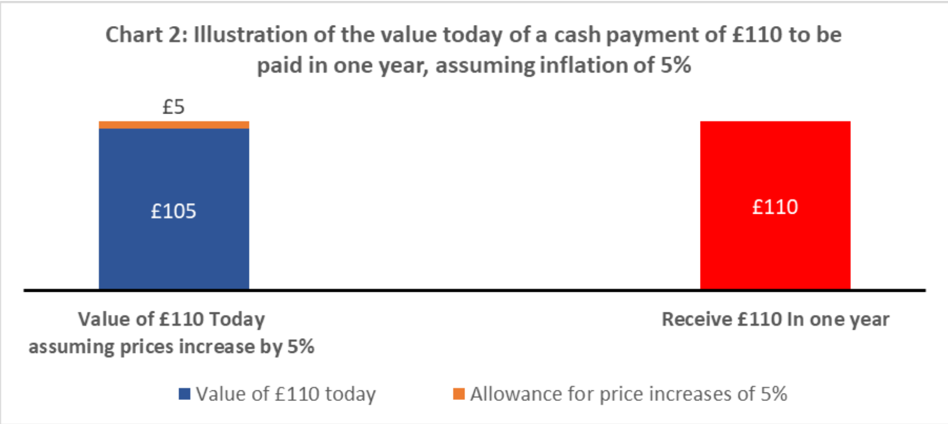
- An investor knows what the interest and capital cash payments will be when they buy the bond. There is no uncertainty.
- Companies have to pay the cash payments to their bondholders first, before they can pay any profits to their shareholders.
- There are quite severe consequences for a government or company that fails to pay its bondholders, which they will seek to avoid.

Some bond investors are prepared to buy bonds issued by more risky companies, which generally pay out higher interest, because they are prepared to take a higher risk of losing some money (increased risk of default) for the chance of a higher return. Some funds may not allow/be limited in their ability to buy these bonds due to the added risk.

3. Why has the value of bonds fallen?

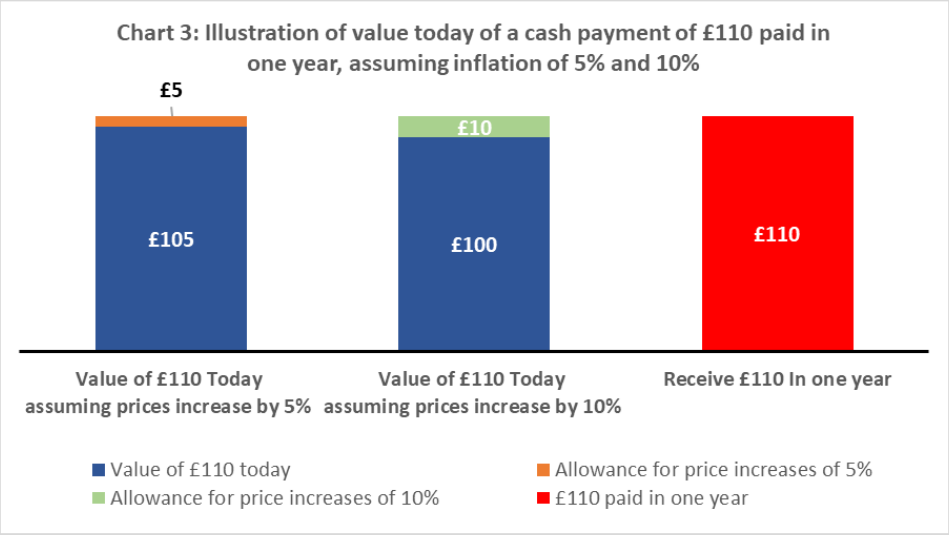
The price of a bond reflects what the investor thinks its future cash payments are worth. There are lots of factors that a bond investor will consider when deciding its value. One factor is future price increases. An investor will want to reduce the risk of the bond's future cash payment not being able to buy the same goods as they could today.

For example, consider a friend who has asked to borrow some money and in return will pay you back £110 in one year. How much should you lend? If you think prices are going to increase by 5% over the year, then the £110 you will get in one year is worth about £105 today. This is shown in Chart 2.



Source: Santander Asset Management UK, June 2022.

If you changed your mind and thought that prices were going to go up by more, say 10% instead of 5% then the £110 in one year is worth less today and you would lend a smaller amount. In this case you would lend £100 instead of £105. This is shown in Chart 3.



Source: Santander Asset Management UK, June 2022.

A key reason for the negative return in bond funds in 2022 has been bond investors reviewing their assumption of future inflation (rise in prices and reduction in purchase power) and increasing it, causing current bond values to fall.

Concerns about higher inflation globally were being considered in 2021 but this increased in 2022 following Russia's invasion of Ukraine. The sanctions imposed on Russia reduced the amount of oil and gas available and increased energy prices. Wheat stored in Ukraine has not been available, contributing to an increase in food prices.[2]

4. What has been done to try and protect the value of investments?

The rules for our funds set out what investments they can and cannot make, and in general require them to be invested in their asset class, e.g. a bond fund should be invested in bonds.

Given this requirement, our bond funds (and several of our multi asset funds) invested in bonds whose price has been more resilient to rising interest rates than the overall bond market. They also reduced their exposure to the extra risks from company bonds, compared to government bonds. These actions could not protect the funds from all of the fall in bond prices seen this year, but it did enable them to deliver a higher return than the bond market.

5. What is the future for bonds?

The increased uncertainty currently in the world makes it harder for investors' assumptions to be correct and bond investors will continue to reassess their assumptions as new information becomes available. For example, to control inflation Central banks, (e.g. the Bank of England and the United States' Federal Reserve) have indicated that future increases in interest rates are likely. If they were to increase interest rates by more than bond investors have assumed, then bond prices may fall further. However, a smaller than expected increase (e.g. because inflation slows faster than expected or economic growth starts to slow down too much) then bond prices may increase.

Our multi asset funds which contain exposure to bonds or our fixed income funds are generally either managed with reference to a benchmark, seeking to either outperform or to provide a level of income. The constituents of the benchmark are impacted by the market conditions described above. Our role as Fund Manager is to manage the downturn and seek to deliver good outcomes to clients. We are closely and continuously monitoring market conditions, evolving investor assumptions built into bond prices and managing the risk to the funds by seeking bonds which may outperform the fund's benchmark or generate the required level of income for the relevant fund. Neither outperformance nor income levels are guaranteed.

Learn more!

Access the latest updates on bonds and investment markets on our website **here**.

Note: Data as at 28 June 2022.

[1] Investing.com, 28 June 2022
[2] The World Bank, 26 April 2022

Important Information

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