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# Script - Income 101

## A guide on fixed income

For investors who would like to earn regular fixed income, apart from bank deposits, they may also consider bonds or bond funds. Buying a bond is like lending money to the bond issuer. As a return, the issuer will pay the bondholder a specific rate of interest, also known as coupon, at periodic intervals throughout the life of the bond, and repay the principal when the bond matures.

If an investor purchases a bond at its face value and holds it to maturity, the return is equal to the fixed income received.

Let's take an example of a 3-year bond purchased at US\$1,000 face value, with a 4% annual coupon. The interest payment each year for the first two years will be US\$40. When the bond matures in the third year, the interest and principal will be US\$1,040. Therefore, the annual total return is 4%.

However, if the investor does not hold the bond to maturity, the prevailing market interest rate should be factored in when calculating the investment return. Since bond prices are inversely related to interest rate movements, a rise in interest rates could see a fall in bond prices, and vice versa. In the worst case scenario, the loss in value of the bond may be greater than the fixed income received, which means the investor will suffer a loss.

## Fixed income investment returns

For dividend-paying funds, investors should take into account not only the funds' net asset value (also known as NAV) but also the dividends paid. Dividends can be paid annually or monthly. The gain or loss in NAV, together with the dividends paid, should be factored in when calculating the total return.

For instance, in the case of bonds, the total return cannot be determined solely based on the change in bond prices. Interest payments should also be taken into account when calculating total return. We must take note that for both bond funds and bonds, a portion of the total return comes from these fixed payments paid. Therefore, we cannot just focus on the change in NAV of the fund or bond prices. This is especially important for bond funds that pay high income distributions.

Taking the US High Yield Index as a hypothetical example, if an investor invested USD10,000 at the beginning of 2006, his/her investment would have grown to approximately USD19,000 after 10 years. Out of which, fixed income received contributed about 55% of the investment value<sup>1</sup>. So don't just focus on the change in NAV, it is also important to look at the contribution of regular income distributions, or dividends, to the total return.

<sup>1</sup> Source: BofA Merrill Lynch, as at 31 December 2015. Monthly data from January 2006 to December 2015.

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