



UGANDA SECURITIES EXCHANGE LTD.

**THE LAYMAN'S GUIDE TO  
INVESTING IN FIXED INCOME  
SECURITIES**

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### *What is a long-term debt security*

Very plainly, a long-term loan on which money is lent to a government or corporation and the lender earns interest on the funds. After a certain period of time the funds are paid back. Investors benefit from long-term *debt* financing by receiving regular interest payments which can be fixed or floating and principal repaid at maturity while investors benefit from long term *equity* financing through capital appreciation and regular dividend payments from strong performing companies. By international capital market standards, long-term debt securities normally have a minimum life span of ten years.

Both issuers of debt and equity securities are issuing funds for projects that require long-term financing and both types of securities have a direct claim against the corporation's cash flows which are valued using the discounted cash flow method. The primary difference being that the investor receives their principal on the bond on the maturity date and can no longer benefit from the future growth of the corporation, while an equity investment does not have a due date and the investor will continue to benefit from the capital appreciation of the corporation.

### *Types of long-term Debt Security*

Bonds are the most common type of long-term debt instruments, which include government, corporate and municipal bonds. Debentures are unsecured bonds that are not pledged against specific assets in case of default, i.e. are secured only by the executives' smiles. Also utilised are convertible bonds that allow the bondholder to exchange it for another security usually debt exchanged for equity. More traditionally, a term loan is a contract under which a borrower agrees to make a series of interest and principal payments on specific dates to the lender - generally a bank. Term loans have speed, flexibility and low issuance costs, while the price of a bond offering is determined by the rates on the market place. The issuing corporation will have normally reviewed the cost of borrowing in the market place before issuing the bond

For your own edification, bills are short term and notes are medium term debt instruments. Commercial paper are short-term obligations issued by banks and corporations.

### *Relevance to the Ugandan Economy*

There is certainly a connection between an active bond market and a developing economy such as Uganda's. Issuance of long-term debt security is relevant to the Ugandan economy because it helps raise funds for projects that require long-term financing whether it is the public sector building infrastructure such as roads, bridges, low income housing and in particular local municipalities, building

hospitals, schools or providing other local services. The private sector may also finance acquisitions, equipment leasing/ purchasing or upgrade materials utilised in their manufacturing processes.

From a fundamental capital market perspective, Ugandans are also able to invest in their national infrastructure, local communities and encourage the growth of the private sector by applying their savings towards the investment of well managed, transparent and successful municipalities and corporations. This in turn addresses two key issues of; (i) mobilising of savings towards investments – poverty reduction and (ii) investing in transparent successful entities – reduction in corruption and utilising the results / rewards scheme. Please bear in mind that the criteria for enlisting an entity on the Exchange ensures that there are transparent financial reporting procedures, among other criteria, required by the regulatory authorities.

### ***Components of a Bond***

A bond issue is generally advertised, offered to the public and actually sold off to many different investors through the normal floatation procedure on the Exchange. Interest rates can be fixed or floating. The primary components of a bond include the: (i) Principal

(ii) Price

(iii) Interest and

(iv) Market Price.

- (i) **The Principal** - When you put up 1,000,000/=, you'll get 1,000,000/= upon maturity. That's your principal and the bond's face value is known as *par*.
- (ii) **The "Bid" Price** - When you read that a Bond costs 98.751, that means 98.751% par value. Therefore the shilling value of the bond is 987,510/= to receive 1,000,000/= at maturity.
- (iii) **The Interest** - Also known as the coupon, is the ongoing income realised until maturity. Various formulas are used based on the type of bond.
- (iv) **The Market Price** - If you want to sell your bond before maturity, the price will depend on market conditions. If interest rates are falling, bond prices rise and investors make money and vice versa rising interest rates will result in selling your bond at a loss.

### ***Risks of a Bond***

Some of the primary risks associated with purchasing a bond are:

- (i) **Market Risks** - the market value of bonds will rise and fall as a function of interest rate fluctuations. This matters if you have to sell your bond before maturity. The shorter the life of the bond the safer it is because it will fluctuate less in price.

- (ii) **Holding Period Risk** - the longer the term of the bond, the greater the risk that you'll have to sell them before maturity.
- (iii) **Inflation Risk** - As prices rise, both your interest and principal lose purchasing power.
- (iv) **Default Risk** - the issuer might not pay on time or at all, in case a company's loans need to be restructured or it goes bankrupt. Although debt instruments are normally paid in preference of equity instruments in cases of liquidation.
- (v) **Credit Risk** - The CMA and USE are presently in conversation with other East African regulatory authorities to design a credit rating scheme for the region, although there are globally recognised rating firms such as Standard and Poors and Moody's that rate firms from AAA - 'least risky / good buy' to C/D - 'most risky / good luck'. Bonds rated from AAA to BAA are regarded as investment grade, which many banks and other institutional investors are permitted by law to hold. The BB to C/D category are treated as junk-grade which the investor holds at considerably higher risk. As this reflects the probability of the issuer going into default, it consequently has a measurable influence on the bond's interest rate and firm's cost of capital.

#### *Why Issue Bonds?*

- (i) Is it more cost effective? As earlier mentioned, the issuing corporation will already have reviewed the costs of borrowing on the market. The financial analysis will determine which is the most economic route to pursue
- (ii) Although, if weighing it against a stock floatation, bond prices are generally more stable thereby reducing the company's exposure during market gyrations.
- (iii) Tax benefits, particularly for municipalities and companies. There are various benefits to be realised by the Stock Exchanges in the region.

#### *Why Invest in Bonds?*

Investing in bonds is regarded as a method of supplementing one's income while attempting to 'hedge' the risks on the market. Sensible portfolio investment would suggest that you clearly acknowledge the risk/reward formula. Meaning, given the reduced risk incurred there will be limited reward which one should complement by investing in stocks to receive a balanced rate of return from your portfolio. Long-term bonds are not always as liquid in case you need to promptly raise funds unlike treasury bills or other equity investments. Municipal bonds normally offer attractive tax benefits for institutional investors.

Easily remembered, bonds should be considered as part of your portfolio of investments because (i) interest payments regularly collected and (ii) they are not as risky as stocks, but still have their own quotient of risk.

A classic example is the successful floatation of the East African Development Bank Bond that was floated on the Uganda Securities Exchange in January 1998. The floatation was a local currency issue worth 10 billion shillings. The issue was oversubscribed and current trading has exceeded 9 billion shillings by institutional investors.

*What does it mean for you and the economy?*

The capacity to raise long-term financing for basic infrastructure that benefits everyone in the economy. Ugandans can now invest their savings in local municipalities and companies that have a history of utilising their funds efficiently. Issuers have an alternative debt-financing instrument – versus traditional term loans – to raising long-term funds. Institutional investors also have an additional vehicle in which to invest their funds on a longer-term basis instead of being limited to treasury bills as safe havens. In conclusion, bonds are instruments that must be used in conjunction with other investment instruments due to the inherent risks associated with their longer life span.