CORPORATE BONDS : “A GOOD INVESTMENT ALTERNATIVE”

- Anmol Goel | AMRG & ASSOCIATES

The participation of retail investors on Indian stock exchanges has significantly increased after the emergence of COVID-19. According to the report of SBI, the number of individual investors in the market has increased by 142 lakh in FY21, with 122.5 lakh new accounts at (CDSL) and 19.7 lakh in NSDL. Furthermore, the markets have progressively improved with Sensex increasing from 28,265 at the beginning of Apr'20 to above 58,000 now.

As we all know that investing in the stock market which has given significant returns also has a higher risk factor. When we talk about investing, diversification into different asset classes is one of its most important aspects which investors thrive for to boost their investment returns while reducing risk.

Corporate bonds which are the debentures issued by the company can be a great investment alternative if a person wants to do a less risky investment and want higher returns as compared with those we get from bank FDs. As bank FDs nowadays are unable to cover inflation and the interest income from the same is taxable leading to loss of wealth for the investors.

Brief Background

A corporate bond is one of the ways for companies to raise money from the market. It is a kind of loan between the corporation and its investor. The investor agrees to provide the company with a fixed amount of money which is treated as the company's debt on which the investor gets periodic interest payments as a return. This is done because issuing shares in the primary market changes the ownership situation of the company whereas issuing bonds doesn’t affect the ownership situation of the company.

Raising capital through issuing equity in the market can dilute its ownership on part of its promoter or institutional shareholders. Bonds provide an organization with the means of raising capital by avoiding its reduction on the existing share capital of shareholders.

But now the question arises why do companies issue bonds instead of borrowing from the banks?

A company may borrow money from a bank, but raising money in the open market is more attractive to the company. This is because the interest that companies pay to bondholders is often lower than the interest that they pay to banks. Banks act as a mediator between those people who save their money and those who want financial leverage (loans), therefore, earning the difference. Issuing bonds in the open market saves interest costs for the company.

Why invest in corporate bonds

Corporate bonds are an excellent choice for investors who are looking for fixed and higher returns. Interest rates on corporate bonds can range from 9% to 13%. Apart from the interest component of corporate bonds, a good corporate bond can yield significant capital gains if sold in the secondary market.

Tax-free bonds are also available in the market which offers an exemption on interest earned as per Section 10 of the Income Tax Act of India, 1961. Having said that these bonds become an excellent choice for investors falling in the highest tax bracket. These bonds are generally issued by a government enterprise to raise funds for a particular purpose. The rate of interest offered on tax-free bonds generally ranges between 5.50 % to 6.50 %, which is fairly attractive while considering the tax exemption on interest for these bonds.

Please note that tax-free bonds have a longer lock-in period that ranges from 10 years to 20 years. You cannot withdraw your money before the maturity date. Some of the commonly found tax-free bonds are of the National Highway Authority of India (NHAI), National Thermal Power Corporation Limited (NTPC), Indian Railways, and Rural Electrification Corporation.

How to invest in bonds

One can easily invest in the bonds in the primary market through Initial public offerings (IPOs) or through open market purchases in the secondary market.

Bonds in a primary market through Initial public offerings (IPO's) are generally issued at a face value of INR 1000 with a lot of minimum 10 bonds. Therefore a minimum investment of INR 10,000 is required to purchase bonds from the primary market. An important point is that in the event of an oversubscription of a bond IPO, the bonds will be allotted on a first-come, first-served basis, unlike IPOs on the stock exchange, which are allotted by lottery. These bonds once issued can also be purchased in the secondary market which can either be bought at a premium or at a discount if lucky enough.

How to calculate the yield of a bond

The essence of yield is the rate of return on a bond investment. Yield is an important concept when investing in bonds because it is a tool used to measure the rate of return of one bond compared to another. This allows you to make an informed decision about which bonds to buy. The yield of a bond is not fixed like the interest rate of a bond as it changes with change in the bond prices, so when the market price of a bond is greater than or less than its face value, the current yield of the bond changes. For example, if you buy an Rs. 1,000 bond with a 7% stated interest rate at Rs. 900, your current yield would be 7.78%.(Rs. 1,000 x .07/Rs.900).

While buying a bond its interest repayment frequency also becomes an important criterion for its selection. Interest-bearing bonds usually have interest repayment frequency of quarterly, semi-annually, annually or at maturity. For example, if we have two bond options i.e Bond A bearing 6%p.a with interest payment frequency quarterly and Bond B bearing 6%P.a with interest payment frequency annually. Bond A will be preferred as due to its compounding effect as its effective yield will be higher than that of bond B.

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Conclusion

Corporate bonds can be a lucrative option for those looking to diversify their portfolio or for those looking for a decent low-risk fixed return. Investing in specified Investing in certain tax-free bonds can be a good tax planning option. Investing in CRISIL's AAA-rated bonds is preferred as it minimizes the risk of default, however, investors should do a proper analysis of the bonds before investing.

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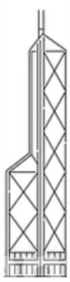

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