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What is a Bond and Why a Bond's Price Will Change Over Time – July 2025

In this memo, we discuss the fundamentals of bonds – a cornerstone in many investment portfolios. Bonds are often perceived as less volatile than stocks; however, understanding bonds and their price dynamics is important for making informed investment decisions.

What is a Bond?

At its core, a bond is essentially an **IOU** issued by a borrower to a lender or investor. Think of it as a loan you make to an entity, which for our client portfolios would normally be a government (sovereign bond), a government agency (agency bond), or a corporation (corporate bond). When you buy a bond, you are lending money to the issuer for a specific period, known as the **maturity date**.

In return for your loan, the issuer promises to pay you two things:

- **Regular Interest Payments:** These are typically paid semi-annually at a fixed interest rate, known as the **coupon rate**. This rate is expressed as a percentage of the bond's **face value** (also called par value), which is the principal amount the issuer will repay you at maturity. For example, a bond with a \$1,000 face value and a 5% coupon rate will pay \$50 of interest per year.
- **The Face Value at Maturity:** On the maturity date, the issuer will repay the original principal amount (\$1,000 in our

example) to whoever is the bondholder at that time. You might have sold it to someone else by the time of its maturity.

Why Do Bond Prices Change? The Forces at Play

While the coupon payments are fixed, the price at which a bond trades in the secondary market (after its initial issuance) can fluctuate significantly. Several key factors drive these price movements:

1. Interest Rate Changes: The most influential factor is the current interest rate for bonds of similar maturity and credit worthiness. Bond prices have an **inverse relationship** with prevailing interest rates.

- **Rising Interest Rates:** If market interest rates rise after a bond is issued, newly issued bonds will need to offer higher coupon rates to attract investors. Existing bonds with lower coupon rates become less attractive in comparison. Consequently, investors will be willing to pay less for these older bonds, causing their prices to fall.
- **Falling Interest Rates:** Conversely, if market interest rates decline, existing bonds with higher coupon rates become more desirable. Investors will be willing to pay a premium for these bonds, driving their prices up.

2. Creditworthiness of the Issuer: The perceived risk of the issuer defaulting on its debt obligations significantly impacts bond prices.

- **Deteriorating Creditworthiness:** If an issuer's financial health weakens (e.g., a company faces bankruptcy risk or a country's economy falters), investors will

demand a higher return to compensate for the increased risk of not getting their principal back. This increased risk translates to a lower bond price. Credit rating agencies like Moody's and Standard & Poor's assess and publish credit ratings to help investors gauge this risk.

- **Improving Creditworthiness:** Conversely, if an issuer's financial situation improves, the perceived risk decreases, and investors may be willing to pay more for its bonds, leading to price appreciation.

3. Time to Maturity: The time remaining until a bond matures also affects its price sensitivity to interest rate changes. Generally, **longer-term bonds are more sensitive to interest rate fluctuations** than shorter-term bonds. This is because many of the coupon payments and the principal repayment occur further in the future, all of which are discounted back to the present using prevailing interest rates. A change in interest rates has a larger cumulative effect over a longer period.

4. Inflation Expectations: Inflation erodes the purchasing power of future fixed payments. If investors expect higher inflation, they will demand a higher yield (and thus a lower price) on bonds to compensate for this erosion.

5. Supply and Demand: Like any other asset, the price of a bond is also influenced by the forces of

supply and demand in the market. If there's high demand for a particular bond (perhaps due to its attractive yield or perceived safety), its price will likely increase. Conversely, if there's a surplus of a particular bond with limited buyers, its price may fall.

In Conclusion:

Understanding that bond prices are not static is essential for investors. While bonds are often considered a safer asset class than stocks, their prices can and do change in response to a variety of economic and issuer-specific factors. By understanding these dynamics, you can make more informed decisions to align with your investment goals and risk tolerance.

If you purchase investment grade bonds and have the intention to hold them to maturity, as is the case with most bonds held in our clients' investment portfolios, then you will receive exactly what you expect over the life of that bond. The price changes are only a notation in your monthly statements, that reflect the price changes described above, but they will ultimately be paid out at stated maturity and at the face value. They will have served their purpose to reducing uncertainty of return while providing some return on investment.

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