Government of Namibia Bonds Overview

Capricorn Asset Management
a member of Capricorn Group

Introduction

This write-up aims to briefly explain the rationale behind including a fixed-rated Government of the Republic of Namibia bond in your investment portfolio, the benefits thereof as well as the risks associated with such an investment.

What is a bond?

Other than a mortgage bond of a bank, an investment bond is something that you invest in. When you (the investor) buy a bond, you are simply loaning some of your money to a borrower (the **issuer** of the bond) for a pre-determined period in exchange for regular and fixed interest payments (called **coupons**) until the period lapses (**maturity**) at which point in time you will receive back the nominal value of your investment.

Why do Governments issue bonds?

The Namibian Government, like any other government, finances its operations mainly through taxation and levies. They use these funds to pay for various government expenditures such as capital projects in the form of construction of roads, schools, dams, etc. and recurrent expenses in the form of salaries for civil servants, maintenance of state assets, fuel, etc. In cases where revenue received from taxation and levies are less than the expenditure, the government finances the difference (i.e. the deficit) by borrowing through issuing Government securities such as bonds.

It also provides an investment opportunity

Apart from financing government operations, bonds also provide additional investment avenues for investors. Although the public has various avenues to invest their savings, the government avenue offers the most secure investment. It rarely happens that a government fails to honour its debt obligations issued in its currency. Thus, these securities tend to be highly marketable and liquid i.e. they are in high demand and can easily change hands in the secondary market.

How does a bond work?

Bonds are capital market instruments because their initial investment term always exceeds 12 months. The Government issues bonds to the market through a primary tender process facilitated by the Bank of Namibia.

Investors apply to buy a certain amount of bonds (the **nominal value** or **face value**) at a specific rate (referred to as the **yield to maturity**). If accepted by the Bank of Namibia, these bonds are issued to the investor in exchange for the agreed investment amount (the **consideration**). The consideration may be more or less than the nominal value, depending on the yield to maturity at which the bonds were bought. Previously, investors would receive a bond certificate as proof of ownership, but nowadays, the owner details are simply kept in a digital register.

The Government, again through the Bank of Namibia, will then make bi-annual interest payments, referred to as coupons, to the investor until the bond's maturity. These coupon dates and coupon rates are fixed and will remain the same regardless of the interest rate movements in the market. An investor will thus receive the same interest amount every six months until the bond matures. The coupon value is calculated as follows:

(Nominal Value of the Bonds X Coupon Rate) / 2

The investor can hold the bonds until maturity. However, bonds are also tradeable instruments that can be sold before the maturity date arrives. This buying and selling of bonds between two willing parties is referred to as secondary trading and is very active in Namibia. Should a bondholder decide to sell the bond, an agreement is reached between the buyer and the seller regarding the amount and rate. Ownership is transferred to the buyer, who will then be the recipient of the coupons until maturity.

At maturity, the Government will repay the investor the nominal value or face value of the bond, at which point the bond transaction is terminated.

What are the benefits of investing in bonds?

There are many benefits to investors in Government of Namibia bonds, of which the following are the most pertinent:

- **Stability:** Bonds are primarily used to provide stability within an investment portfolio. The volatility of bonds is considerably less than other investments such as equity, property or foreign investments. By including bonds in your investment portfolio, the volatility and uncertainty are reduced to a level acceptable and in line with the investor's risk profile.
- **Consistency:** Bonds provide a regular and consistent income stream in the form of coupon payments. This is highly beneficial compared to the uncertainty of income distributions such as dividends or even floating rate interest payments. Investors can budget and plan on the precision of these coupon payments which is appealing to those investors who require income from their investments to maintain their standard of living.
- **Capital preservation:** Bonds are an excellent way to preserve your capital because the Government guarantees the full repayment of your investment at maturity. Many other investments do not carry such an explicit guarantee; thus, to have that peace of mind that the capital is preserved is highly valued by most investors, especially the more conservative investors.
- **Diversification:** Bonds can help offset the risk to more volatile asset classes like equity, property and foreign investments. It is often the case that equity investments and bonds move in different directions simultaneously (referred to as negative correlation) which provides an investment portfolio with a form of hedge against weaker equity performances. For instance, if the economy is under strain, equity investments, in general, are likely to be under pressure; however, at the same time, interest rates may decline to stimulate the economy, which in turn is primarily positive for bonds.
- **Tax-free returns:** Section (16)(1)(1) of the Namibia Income Tax Act of 1981 exempts interest income received by or accrued to any person (other than a company) or any external company not carrying on business in Namibia from bonds issued by the Government. Capital gains are usually not taxable; thus, for investors buying bonds to hold them until maturity, the coupon payments would be tax-free. However, should a taxpayer's activity of making capital gains be of such a nature that it can be construed as trading, it may be taxable. For those investors that trade before maturity we recommend that the taxability of capital gains should be referred to Inland Revenue.

What are the risks of investing in bonds?

Although bonds are highly beneficial and recommended for most longer-term investment portfolios, there are also some drawbacks to investing in bonds, which the following should be taken note of:

- **Deprived liquidity:** Because bonds are long term investments, your money is locked for an extended period. Although bonds are tradeable instruments and can be converted into cash quite quickly in the Namibian secondary capital market, investors still stand the chance of realising a capital loss when selling before maturity in adverse market conditions.
- **Interest rate risk:** When you buy a bond, you immediately fix the rate of return you will receive for the entire period until maturity. Although this fixed rate is usually higher than what is available in the market in terms of floating-rate investments, interest rates may rise to such an extent that the fixed rate at which you are earning is no longer attractive compared to floating rate investments.
- **Capital loss:** Although your capital is preserved should you hold the bond until maturity, investors stand a chance of realising a capital loss if they decide to sell the bond before maturity. For instance, should you buy a bond at a yield to maturity of 10% and then later on due to some market event, e.g. rising expectations of the issuer not being able to repay the debt, the market suddenly expects that bond to trade at 11% to compensate for the higher risk, you will realise a capital loss if you are forced to sell the bond. If you, however, keep the bond until maturity, then these market prices will not have a negative effect on your investment.

- **Default risk:** Although Government bonds are relatively safe, they are not entirely risk-free. If the Government defaults (meaning they are unable to repay the debt at maturity), the investor risks losing out not only on the coupon payments but on the nominal repayment at maturity as well. Given the current situation in terms of Government finances, we are comfortable that this risk is relatively low.
- **Inflation risk:** When you buy a bond, you will receive back the nominal value after several years. The risk is that, due to inflation, the purchasing power of the maturity amount will be substantially less than that of the nominal value at the onset. Suppose the coupon payments are not reinvested in some investment vehicle but used to cover financial obligations, then investors may be surprised at maturity to learn that the value of their investment has deteriorated over time.

Are bonds right for you?

Bonds have their pros and cons, so the question remains: Should you invest in bonds? The following sensible scenarios may encourage you to consider investing in bonds:

- If you are heavily invested in equity and property, bonds are an excellent way to diversify your portfolio and protect yourself from market volatility. Bonds can play a vital stabilising role within your investment portfolio, without which the volatility may be intolerable.
- If you are the risk-averse type who truly cannot bear the thought of losing money, bonds might be a suitable investment for you. The capital preservation element of bonds is essential especially for the more conservative investor.
- Another reason to consider bonds is if you are near retirement or already retired. At that point in your life, you may not have the time to ride out stock market downturns, in which case bonds are a safer place for your money. Most people are advised to shift away from stocks and into bonds as they get older, provided you don't make the mistake of discarding your stocks completely at retirement. The consistency of bond income streams is highly beneficial to retirees.

How to buy bonds

If you have weighed up the information regarding bond investments and are keen on investing, the question to follow is how to go about it. Unlike shares traded by large numbers on a public exchange, bonds are not that easy to buy and sell. Bonds are sold into the market through primary tenders by the Bank of Namibia, as explained above, but are limited to a number of authorised tender participants. Bonds are also traded in the secondary market over the counter, which means investors must buy them from either one of these participants or other private investors.

The problem with this system is that, since bond transactions don't occur in a centralised location, investors have a more challenging time knowing whether they are getting a fair price. Fortunately, the secondary market in Namibia is quite developed and active, and bond rates are easily accessible and even visible in the market through most major media outlets, financial intermediaries, asset managers and banks. The Bank of Namibia website also has a record of all the primary tender rates in recent history.

Capricorn Asset Management is the only local asset management firm that manages a bond unit trust fund in Namibia, namely the Capricorn Bond Fund, and as such is well experienced in advising our clients regarding bond investments.

Should you wish to participate in a primary bond tender auction of the Bank of Namibia or trading bonds in the secondary market, please complete the Bond Purchase Order Form (B-7).

For more information, please contact us at:

- Tel: 061 299 1950
- Email: cam.info@capricorn.com.na
- Website: www.cam.com.na

Frequently asked questions

What is the yield-to-maturity of a bond?

A bond's yield-to-maturity (YTM) is the best indicator of the annual income that an investor can expect to earn from settlement date up to maturity. In more complex terms, it is the internal rate of return (IRR) required for the present value of all the future cash flows of the bond (maturity value and coupon payments) to equal the current bond price. In other words, it is the rate that discounts all the bond's future cash flows such that their present value is equal to the current purchasing price of the bond. It is important to note that the YTM assumes that all coupon payments are reinvested at a yield equivalent to the YTM and that the bond is held to maturity.

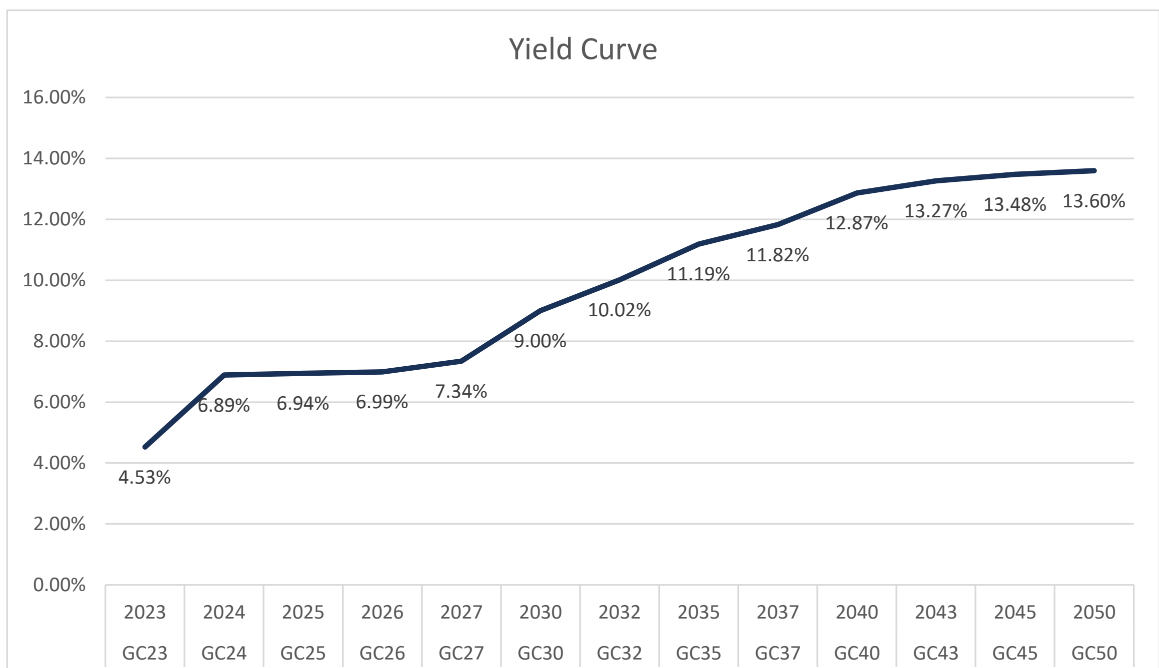
Why is the purchase price sometimes more or less than the nominal value/ maturity value?

To answer this question, it is important to understand the difference between the nominal value of a bond and the bond's purchase price, referred to as the "consideration". The nominal value is the "face value" of the bond and is equal to the maturity amount, i.e. the amount the investor will receive back when the bond matures. The consideration is the amount that the investor pays on the settlement date to acquire the bond.

The consideration is more often than not different from the nominal value because of the difference between the yield-to-maturity rate (YTM) and the coupon rate. The coupon rate is a fixed rate and is used to calculate the precise coupon amount that will be paid to the investor every six months ((Nominal value X coupon rate) / 2). These coupon cash flows are fixed as well as the maturity amount – nothing will change that. However, the YTM is the rate at which the bond was sold to the investor and is the rate at which all future cashflows (coupons and maturity value) are discounted to present value. So, if the YTM is more than the coupon rate, it means the selling rate is more than the actual coupons that the client will receive, and to adjust or compensate for this, the investor will pay an amount less than the nominal value. This is referred to as a discount bond. If, however, the YTM is less than the coupon rate of the bond, the coupon payments will then be more than the promised rate, and to compensate for that, the investor will have to pay more upfront as part of the purchase price. This will result in the consideration being more than the nominal value and is referred to as a premium bond.

How are bonds priced?

The yield-to-maturity (YTM) of a bond is priced from a "yield curve" which is a line that plots the different yields (interest rates) of bonds with differing maturity dates. A typical yield curve would look like this:



You can expect to earn a higher return the longer the term of the bond. The slope of the yield curve gives an idea of future interest rate changes and economic activity. The Namibian bond yields are derived from the South African bond yields plus an added "margin" to compensate for the perceived higher default risk of the Namibian government compared to that of SA. The lower liquidity in Namibia in comparison to SA also adds to this margin. So basically, the Namibian market has an agreed margin rate above the SA rates and trading is primarily priced on this Namibian yield curve. Other market factors such as the supply and demand of our local bonds will also determine the yields of the Namibian bonds.

Why do bond values go up and down?

To answer this, it is essential to note that there is always an inverse relationship between bond rates (or yields) and bond prices. In other words, if bond rates go up, then bond prices (and their subsequent value) will decrease and vice versa. This is nothing else than the "interest rate risk" of a bond, as explained earlier.

Bonds with longer maturities incur significantly higher interest rate risk than those with shorter maturities meaning that the longer the term of the bond, the more heightened the price change is to yield movements. The reason being that a bond yield is fixed from the day it is bought until maturity.

This rate at which the bond was bought (and fixed at) was the market's view of a fair rate for the bond given the interest rate view and default risk. If something would change in the market to price the bond higher, say, for instance, the higher expectation of default, then the bond that the investor has bought already will have to reprice (referred to as "mark-to-market") to this new reality and rate. If a bond yield increases, all existing bonds already issued will price lower. Say, for instance, you bought a GC30 at 10% in 2019. Now in 2020, due to the higher perceived default risk of government (as a result of higher government debt), future GC30 investors want additional compensation for this higher risk and now requires 11% for such a bond. Your bond of 10% will then have to be repriced to 11% and, as a result, will be worth less. It is important to note that this repricing is only the market's view of the value of the bond and will not have any negative impact on the value of your bond if you do not sell it. If you hold your bond until maturity, the same maturity amount will be paid out irrespective of the yield volatility before maturity.