KMI report - Corporate bonds –What are they?

Corporate bonds are issued as a way of raising money for businesses - it's essentially a certificate of debt issued by major companies.

Stacking up: Bonds deliver a good steady return

When you buy bonds you are lending money to a company in exchange for an IOU. The IOU has a term and at maturity (typically five or ten years) the sum invested is returned in full.

The only thing that might stop this is if the company actually goes bust. The bond also has a coupon - the amount of interest paid, say 5%.

How they work: As long as you hold the bond, you are paid the coupon every year. If you keep it to maturity you will receive your capital back.

Crucially, the coupon is a fixed percentage of the cover price of the bond.

So if you buy a £10,000 ten year bond with a 5% return, you will receive £500 each year in interest, and after ten years you will get your £10,000 back.

How we buy them: In recent years companies have increasingly targeted investors direct for corporate bonds.

In February 2010, The London Stock Exchange launched a retail bond market in which corporate bonds could be traded - encouraging more firms to go direct to personal investors. These have been dubbed retail corporate bonds and are bought and sold through brokers and investment platforms.

One example of a highly popular corporate bond, issued by a larger company that aimed to take advantage of this was Tesco. Tesco Bank launched its 5.2% seven year bonds in February 2011, which aimed to raise between £50m - £100m. It was highly successful and sold £125m worth. It followed this up with a new Tesco Bank inflation-linked eight-year bond in December 2011. In May 2012, Tesco returned to tempt income-hungry investors with a 5% eight-year bond to 2020. The LSE bond market has slowly picked up pace since launch and investors can expect more fundraising launches like Tesco's.

It has proved a small but popular niche for investors in recent years, with bonds from names such as National Grid, Provident Financial and BT, also proving popular.

What is a Coupon: It is the interest rate paid annually by the issuer of the bond

What is a Yield: It is the annual interest rate paid by the bond, calculated on the price paid for the bond on the secondary market

What is the Secondary Market: Just like the Stock Markets, there is a daily traded market for Corporate bonds. The key difference in flexibility between a corporate bond and fixed rate savings is that during its lifetime a market-traded corporate bond can be bought and sold and its price will change according to the market.

So if you hold a ten-year corporate bond, you personally don't have to wait ten years to cash-in the bond. You could sell it at any point.

But if you do want to sell it on, between its issue and maturity date the bond's price will rise and fall and at any given moment it may be worth more or less than you paid for it. You could therefore incur a capital loss or make a capital gain on the investment. An example of this is Tesco Personal Finance's 5.2% bond issued in early 2011, which runs for seven years. It is currently trading above face value, at £104.20, highlighting investor's appetites for the interest paid.

When bonds are trading above or below their initial level they are said to be trading above or below par. If you buy a corporate bond second-hand, you will get the right to be repaid its value at maturity and its coupon interest rate until then, but paying above or below par for the bond itself will change the income return.

This means that with traded second-hand bonds a yield to maturity is also typically quoted. If you buy at a discount, your yield to maturity will be higher than the original coupon rate. If you buy above par it will be lower.