

EASTERN CARIBBEAN CENTRAL BANK



INVESTMENT INSIGHTS

3. Investing in Shares, Bonds and Treasury Bills

Shares

Purchasers of shares, also called stock, become owners and have equity in the company. The more shares you own, the greater your share of ownership in the company. Most corporations offer two types of shares - ordinary or common shares, and preferred or preference shares.

Purchasers of common shares become owners “in common” with other shareholders, and are eligible to vote in the election of directors, and to receive a proportionate but unspecified claim on the company’s profits. Profits are usually distributed as dividends declared periodically by the company’s directors, and paid out as either cash or additional shares. Dividend payments vary in proportion to the level of profits. When the company does well, you will be able to receive a portion of its profits. But, on the other hand, the company might not in fact pay dividends in those years in which it makes little or no profit.

Holders of preference shares are entitled to certain rights and privileges over ordinary shareholders. They have the right to receive dividends at a fixed rate, prior to the payment of dividends to ordinary shareholders. If the company fails, goes bankrupt or is liquidated, preferred shareholders can receive a proportionate share of the company’s assets, before the holders of common shares. However, they do not have voting rights.

All shareholders derive three main benefits from investing in shares. These are:

- (i) Growth in the value of shares over time, with the shares being worth more than the price paid for them. This is called capital appreciation.
- (ii) Income, in the form of dividends, and
- (iii) The opportunity to participate in the development of local enterprises, at the same time contributing to and benefiting from the growth and development of economy.

But there is an element of risk in every investment. So, although the value of stocks usually increases over time, this may not always be the case. Factors such as poor company performance, bad economic conditions and unfavourable investor perception of the company could result in decreases in the value of the stock.

TREASURY BILLS

Unlike shares, which represent equity ownership in a company, treasury bills commonly referred to as T-bills, are debt instruments issued by governments. They can basically be described as short-term loans to the issuer.

EASTERN CARIBBEAN CENTRAL BANK



INVESTMENT INSIGHTS

3. Investing in Shares, Bonds and Treasury Bills

Treasury Bills are issued for a term of one year or less; so a government may issue a 91 or a 181-day treasury bill, any period that is less than a year. By purchasing the T-bill, the investor in fact lends money to the government for the specified time. When repayment becomes due, that is at maturity of the loan, the government will repay the investor the full value of the bill, called the face value.

Treasury bills are usually sold at a discount that is at less than the face value. But because the investor is repaid at the face value, the investor will receive more money than was actually paid. The difference between the purchase price of the Treasury bill and the amount repaid at maturity represents the interest or the return on the investment. Let us look at an example.

The government issues a treasury bill for 91 days, with a value of \$10,000. The investor purchases the bill at the discount rate of \$9,500. At day 91, when the T-bill matures, the investor will be repaid at the face value of the bill which is \$10,000, a gain of EC\$500.00. This \$500.00 represents the interest earned by the investor.

Bonds

Like treasury bills, bonds are debt instruments; however they are long-term instruments, issued for a period of five to thirty years, by both companies and governments. Bonds issued by governments are called treasury bonds, while those issued by companies are called corporate bonds.

The investor lends money to the government or company at a fixed interest rate and for an agreed period. The amount of the bond is called the principal. Bonds pay a fixed amount of interest every year until maturity, at which point the bond's face value is redeemed. The interest is the investor's return on his investment.

The value of bonds moves in a direction opposite to interest rates. If interest rates go up, new bonds will be offered at a higher rate; however the bondholder will continue to receive the agreed lower rate, the bond therefore decreasing in value. The converse is also true. When interest rates go down, new bonds will offer less, while your old bond will continue to earn the previously agreed rate. The longer the term of the bond therefore, the greater the possibility that the price of the bond will be affected by factors such as inflation. A 30-year bond price is likely to fluctuate more than a 5-year bond since the interest rate is locked in for a longer period. This we call interest rate risk, one of the risks associated with bonds. Because Treasury Bills are short-term instruments they tend to be less vulnerable to interest rate risk fluctuations than bonds.

EASTERN CARIBBEAN CENTRAL BANK



INVESTMENT INSIGHTS

3. Investing in Shares, Bonds and Treasury Bills

There is also the possibility that the borrower will not be able to repay the loan. This is called the credit risk, and in such a case the investor could lose some or all of the money invested. However treasury bills and bonds are considered safe, since the governments guarantee that the investor will receive full principal on maturity.

Every investment holds some degree of risk. The rule of thumb is that the higher the return, the higher the level of risk, the logic being that investors willing to accept the higher risk level should be compensated. But each investor will need to determine his or her risk-tolerance level, that is the level of risk one is willing and able to incur. A broker dealer can assist investors in understanding and evaluating these and other investment related risks.