Knowledge sheet

Shares and bonds

An overview of shares and bonds

What is a share?

A share is an ownership interest in a company. Anyone who acquires a share becomes a co-owner (shareholder) of a company (or more precisely, of a joint-stock company). Shareholders thus have the right to a share of the company's profits, and are entitled to a share of the liquidation proceeds if the company is liquidated. As co-owners, shareholders have a voting right at the company's annual general meeting (AGM) commensurate with their interest.

Some share-related terms

- **Dividend** A divided is the portion of its profits a company distributes to its shareholders. The dividend, which is usually paid once a year, depends on the company's results.
- **Nominal (or par) value** The nominal value, also known as par value, is the fixed amount specified on the share. It is calculated as follows: nominal value = share capital divided by number of shares. Since May 2001, the minimum nominal value has been set at CHF 0.01. The nominal value indicates the interest an investor buying a share acquires in the share capital of the company in question. The nominal value has no bearing on a share's market price or its issue price (the price for initial purchase).
- **Share price (market price)** The share price indicates the current value of a share. This is the price at which the share can be bought or sold. It changes all the time, and can be many times more (or less) than the nominal value.

What is a bond?

A bond is a debt security issued by a company or a public-law entity (such as a state or municipality). Anyone acquiring a bond therefore has a claim against the borrower. The person acquiring the bond (the bondholder) is thus entitled to repayment of the amount of the debt at the end of the term of the bond, and is paid interest (in most cases annually) at a pre-agreed rate during this term. Bonds often have a term of between five and ten years.

Some bond-related terms

- **Coupon** The coupon is the pre-determined interest paid to the bondholders (in most cases annually) by the company or government that issues a bond. The interest is expressed as a percentage of the nominal value, for example 5%.
- **Nominal (or par) value** The nominal value of a bond indicates the amount of the claim that is to be paid back to the bondholders at the end of the term. The actual current value of the bond may deviate from its nominal value.
- **Bond price (market price)** The bond price indicates the current value at which a bond can be bought or sold. It is expressed as a percentage of the nominal value, and in most cases is close to 100%, or at least between 90% and 110%.

What is the purpose of shares and bonds?

From the point of view of investors, shares and bonds are two of the many ways of investing their savings on the capital market. From the point of view of the issuer – i.e. the company or, in the case of bonds, the company or government – issuing shares and bonds are two different ways of obtaining new financial resources, for example to fund investments. From the company's point of view, shares represent its own capital (equity), and bonds represent borrowed capital (debt) that has to be repaid after a certain period.

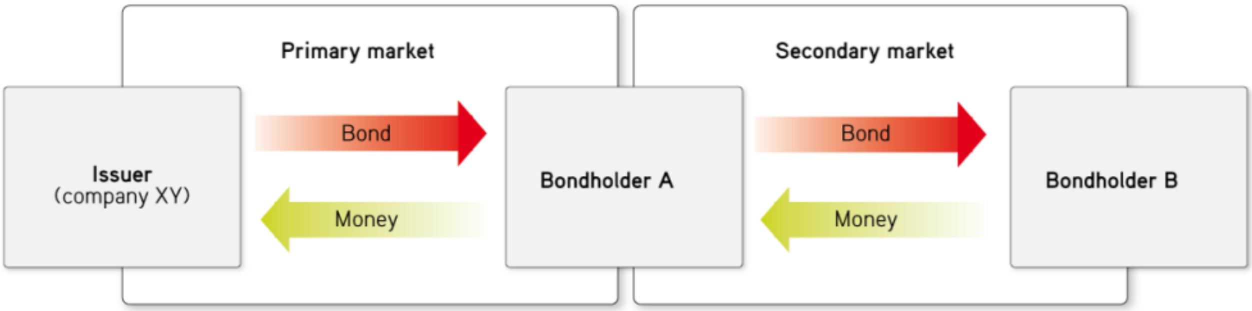
How and where are shares and bonds traded?

The difference between the primary and secondary market

When it comes to trading shares and bonds a distinction is made between the primary and the secondary market. When a company issues new shares or bonds, these are initially placed on the primary market. This is where new shares or bonds are first acquired by buyers. In return, the issuer of the shares or bonds receives money. In most cases this initial offering (issue) is carried out by banks in return for a fee. Once

the new shares and bonds are in circulation, however, their owners can sell their securities to someone else at any time.
This is done on the secondary market. The secondary market is where owners of shares and bonds sell their securities to new buyers. Private retail investors buying shares or bonds typically do so on the secondary market. In this case the money passes from the new buyer to the previous owner of the securities. The entity that issued the share or bond does not receive any money when the securities are bought or sold on the secondary market; it just gets new shareholders or new creditors.

Primary versus secondary market (taking the example of bonds)



Exchange and over-the-counter trading

Securities such as shares and bonds can be traded both on an exchange or off-exchange (over the counter). Exchanges are well organised markets that operate in accordance with strict rules and provide a platform for low-cost, liquid and transparent trading. Anyone wanting to buy or sell shares or bonds on an exchange has to submit instructions to an affiliated trader, typically a bank. As on other markets, the price of shares and bonds is determined by supply and demand. Trading outside an exchange is known as over-the-counter (OTC) trading. The shares of small companies are often held by families and are not traded on an exchange. In this case, shares are bought and sold via a bank, for example, and often by phone.

Fees: an important detail

Various fees and charges have to be paid when shares and bonds are traded. The banks charge a fee (brokerage fee) for each purchase or sale of shares and bonds as well as a fee (custody or safekeeping fee) for the administration of the securities. These fees vary from bank to bank. Added to this, depending on the stock exchange and country, there are various stock exchange fees and statutory taxes and duties to the government. Basically the more frequently investors buy and sell securities, the more fees they will incur.

Shares and bonds from the investor's perspective: the differences

Shares are riskier than bonds

Whether they're buying shares or bonds, buyers run the risk of loss, and in the worst case of losing their entire investment. These risks are much higher for shares than for bonds. This is borne out by experience: while fluctuations in the price of bonds are usually limited, share prices regularly experience great fluctuations, and significant losses are not uncommon. The fact that shares are fundamentally riskier than bonds also becomes clear when a company goes bankrupt. If a company declares bankruptcy, and provided there are sufficient liquidation proceeds, the bondholders –

The returns on shares and bonds are calculated as follows

Shares

$$\frac{(\text{selling price} - \text{purchase price}) + \text{dividends}}{\text{purchase price}}$$

as creditors of the company – are repaid before the shareholders. So even in the case of bankruptcy there are usually sufficient proceeds for a partial repayment to the bondholders, while for shareholders a total loss is much more likely.

Shares promise greater returns than bonds

Return is the profit achieved as a percentage of the capital invested. If you invest CHF 100 in bonds and after a year have made a gain of CHF 5, your annual return is 5%.
Over the long term, shares record significantly higher returns on average than bonds. The higher potential returns on shares are evident when the potential gains available to the investors are considered.
The gains for shareholders comprise any dividends they are paid and the possibility of price gains if the price of the share is higher when they sell than when they bought it. Bondholders receive interest and, if the price of the bond increases, also a price gain. The difference is that dividends and share prices can increase massively – in theory without any limit – if a company generates high profits. By contrast the interest paid by bonds is fixed, and bond prices are unlikely to increase much beyond the nominal value. Since the amount repaid when the bond matures is limited to the nominal value, the increase in the value of a bond is also restricted.

Greater returns mean greater risks

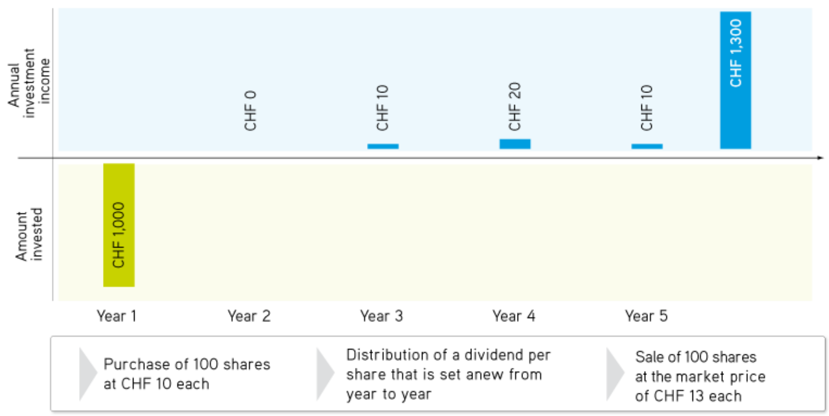
So if you invest in shares you can expect higher returns over long periods, for example 20 years, than on bonds. However, you also have to accept significantly higher risks. For their part bonds, usually at least, are more profitable but also riskier than a standard bank savings account. These comparisons are no coincidence. They correspond to a general rule of thumb on the financial markets: the higher the return on an investment, the greater the risk. This makes sense, because the high return is a reward for taking a big risk.

Bonds

$$\frac{(\text{selling amount} - \text{purchase amount}) + \text{amount of interest}}{\text{purchase amount}}$$

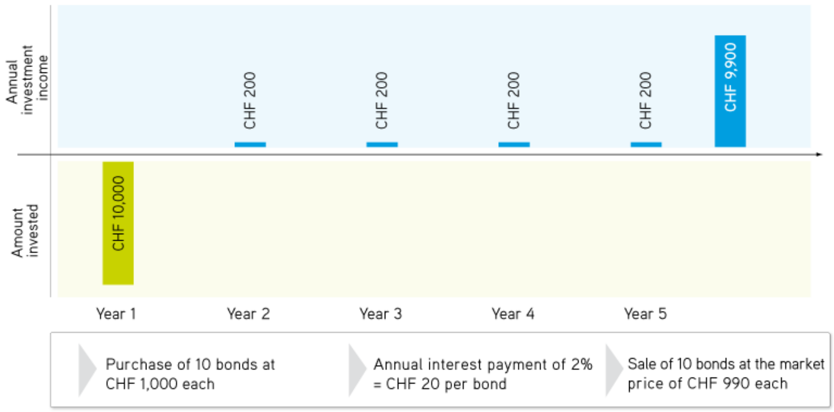
Examples of income and gains on shares

A buyer acquires 100 shares for CHF 10 each (Year 1). In the subsequent years the company pays the shareholder dividends of CHF 0 (Year 2), CHF 10 (Year 3), CHF 20 (Year 4) and CHF 10 (Year 5) on their 100 shares. After receiving the dividend in Year 5, the shareholder sells the 100 shares at a market price of CHF 13. The investment (without compound interest) thus earns them a profit (gain) of CHF 1,300 + CHF 10 + CHF 20 + CHF 10 – CHF 1,000 = CHF 340.



Examples of income and gains on bonds

A buyer acquires 10 bonds at a nominal value of CHF 1,000 each for the price of CHF 1,000 per bond (Year 1). Each year they receive an interest payment of 2%, in other words CHF 20 per bond (Years 2 to 5). Immediately after receiving the interest payment in Year 5, they sell the bonds at a market price of CHF 990 each The investment (without compound interest) thus earns them a profit (gain) of CHF 9,900 + (4 x CHF 200) – CHF 10,000 = CHF 700.



Important differences between shares and bonds

	Shares	Bonds
Buyer's status	Co-owner (owns a share of the company)	Creditor (holds a claim on the company or government)
Buyer's rights	Entitled to share of profits (dividend) and to a share of the proceeds on liquidation of the company	Entitled to interest (coupon) payments and to repayment of the bond (at nominal value) on its maturity
Voting right	Yes	No
Type of capital from issuer (company) perspective	Equity	Debt
Order of priority of payment in the event of bankruptcy	After the bondholders (and after all other persons with a rightful claim)	Before the shareholders (but after employee claims, for example)
Quoted price	Price per share	Price in percent of nominal value
Term	Indefinite (or until company is liquidated)	Limited (defined for each bond, e.g. 10 years)
Potential gains for investors	Dividends and possible price gains are unlimited on the upside (average long-term returns greater than on bonds)	Coupon is fixed, meaning that it is hardly possible for the price of the bond to increase far beyond its nominal value (average long-term returns less than on shares)
Risks for investors	Greater than with bonds: large price fluctuations, and total loss likely in the event of bankruptcy	Lower than with shares: price fluctuations limited, but total loss also possible in extreme cases

Conclusion: Who should buy shares or bonds?

Most people will put their first savings in a bank account. Once you have saved a certain amount, the question is whether to also invest in bonds and shares, and if so how much. Objectively speaking, there is no single right answer here. The question has to be addressed on a case-by-case basis, and depends on the investor's appetite for risk. People who are prepared to risk greater losses in exchange for greater returns, and can also cope with these losses financially if necessary, can invest a larger proportion of their savings in shares. Those who are risk-averse, by contrast,

should rather invest in bonds.
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The investment horizon also has to be taken into consideration: If you don't need your savings in the short term, you'll be more able to invest in shares. In any case, a general piece of advice applies: don't risk everything on the shares or bonds of a single company. If you invest, it's better to buy securities issued by different companies and states, because this reduces the risk of your overall investment. An interesting option is investment funds, which hold a portfolio of different shares and/or bonds.