

What is an index-linked bond?

An index-linked bond is a bond with coupon payments and / or principal repayments linked to a certain index. In theory, a bond can be indexed against almost all public indices. The index typically reflects inflation, but in theory it could also be the income of a company, economic growth, the development of commodity prices or the development of a currency pair.

An inflation-linked bond is one example of index-linked bonds. The advantage of these index-linked bonds is that they offer investors protection against fluctuations in inflation by linking the coupon payments and / or principal repayments of

a bond to a consumer price index. The advantage of using a national consumer price index is that these are well-known, transparent and published regularly.

Governments are typically large issuers of index-linked bonds. The largest issuers are the US and the UK, but also France, Italy, Mexico and Turkey have issued inflation-linked bonds on a large scale.

Sovereign issuers can typically be grouped into three categories.

Pros and cons

Index-linked bonds

Pros

- Inflation-linked bonds offer investors a long-term asset with a fixed real return, which has no inflation risk.
- This will typically be during periods with risk of overheating of the economy or during periods with stagflation.
- Inflation-linked bonds typically have low correlation to other asset classes (equities, commodities, etc.), which is why they may be attractive from a portfolio perspective.

Cons

- Indexed bonds are typically less liquid than nominal bonds, which often results in a liquidity premium.
- During periods of market unrest, liquidity may be adversely affected.
- During periods with deflation, there is a risk of a reduction in the principal. But this depends on the structure of the bond.
- The coupon is typically lower than on nominal bonds, which may be a disadvantage to cash flow-based investors.

1. Countries with extremely high inflation rates, making index-linked bonds the only available option to raise capital for these countries.
2. Countries which want to add credibility to an anti-inflationary policy and which attempt to respond to inflation-concerned investors.

3. Issuing countries which want to support and respond to welfare challenges in relation to, e.g., pension obligations, etc.

Index-linked bonds are also offered by private issuers, including financial and non-financial companies.

What index-linked bonds offer

On a nominal bond, the coupon is the nominal interest received by bondholders. But for an investor, inflation reduces the purchasing power of the interest and repayments received. The interest, which the bondholders receive when adjusted for inflation, is the real interest. This roughly corresponds to nominal interest minus inflation.

If you increase the coupon payments and / or the principal repayments in line with the increase in the consumer price index, as is offered by inflation-indexed bonds, the inflation risk can be eliminated and purchasing power maintained.

Indexation in actual practice

Different methods are used to link cash flows to an indexed bond and a specific index. The link can be made via interest payments, repayments, the principal or all three elements.

The most typical indexation is principal-indexed bonds where a fixed coupon is paid, but on the basis of a principal, which grows in step with increases in the index during the maturity period of the bond. In this way, both interest and the repayment of the principal are adjusted for inflation.

There are also zero coupon indexed bonds, interest indexed bonds and indexed annuity bonds.

Return

Inflation-linked bonds are securities which protect the purchasing power of the investor, as the bond comes with a fixed real coupon. But just like nominal bonds where the price moves as a reaction to nominal changes in the market rate, the price of an index-linked bond will increase when the real interest rate falls and conversely the price will fall when the real interest rate rises.

If you risk a period of deflation, an inflation-linked bond investor may risk that the principal falls below the par value. Many issuing countries offer a floor

under the principal so that the principal will always be at least equal par value at maturity of the bond.

About risk

The risk on index-linked bonds is reminiscent of the risk on nominal bonds with interest, credit and liquidity risk.

If you invest in an index-linked bond denominated in a currency other than your base currency, you also assume a currency risk.

When using benchmarks (e.g. interest rate benchmarks) in index-linked bonds, you must be aware of the risk that these benchmarks are or can be subject to national, international or other initiatives, which may mean that the composition of the benchmark is changed or that the benchmark completely disappears.

Further information is available at:

www.jyskebank.dk/omjyskebank/aftaler/fallbackplans

Index-linked bonds are categorised as red, according to the risk classification.

Read more about the risk classification of investment products at:

www.jyskebank.dk/investeringsinfo.

We recommend that you seek advice from professional advisers about any accounting and tax consequences before you buy index-linked bonds.

What you should know before trading

We recommend that your investment profile is reviewed before you engage in transactions. Your relationship manager can help you with that. We also recommend that you contact your relationship manager if you have any questions in relation to the fact sheet - or if, generally, you would like to have some points clarified.

Tax

We give advice on tax issues in connection with specific transactions. However, the tax rules differ depending on whether you trade as a private individual, as a personally owned enterprise, as a company or if you invest retirement money.

If you wish to learn about the specific importance of the tax rules for you, we recommend that you consult your accountant