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# Should you Invest in Bonds Rather than Repos?

Repurchase agreements and bonds are two financial instruments that are widely used in Jamaica and around the world. But how well does the market understand the two? How do you decide which is better, and when should you switch from one to the other? A few of our colleagues recently asked us to make a distinction, so here we go.

A repurchase agreement (repo) is a short-term borrowing agreement between institutional or government securities dealers, which is less than one year. In the case of repos, a dealer sells government securities and other money market financial instruments to investors, typically overnight, and then buys them back the next day at a slightly higher price. The implicit overnight interest rate is that small price difference. Even though repos are short-term, these agreements provide a level of assurance to the buyer of the security merely because they attract interest and are backed by collateral. The collateral in a repurchase agreement is the security purchased by the buyer; this security ensures that both parties' financial needs are met. Typically, repos are used to raise short-term capital. They are also a common tool used by central banks to conduct open market operations.

A bond, on the other hand, typically has a tenor of more than a year and may even be issued in perpetuity. In its most basic form, a bond is a loan from an investor to a borrower, usually a company or government. Companies, municipalities, and sovereign governments often use bonds to fund projects and operations. The first bondholder can sell bonds to other investors after they are issued, which means that a bond investor is not required to hold a bond until it matures. Bonds are also frequently repurchased by the borrower or "called" when interest rates fall or the borrower's credit improves, allowing it to release new bonds at a lower cost. In contrast to a repo, which is usually a very secure investment, a bond may fall anywhere on the credit spectrum from investment grade and very secure to "junk" and very risky.

Now that we have covered the basics of each, we will now look at whether it's a good idea to switch from a repo to a bond, a question that has been raised by a few clients recently. However, a 'right answer' to this question is highly dependent on each client's individual scenario and circumstances. In any case, we will try to provide a general answer here.

Assume we have a client who is undecided about making the switch. The client is currently invested in a repo with a maturity of less than a year but would like to purchase a bond with a maturity of five years that is 'investment grade.' The bond and the repo are both denominated in US dollars. In today's investment environment, where interest rates have been extremely low for an extended period, some clients have been able to profitably invest in US dollar repurchase agreements with coupons that are higher than the yield on some investment-grade bonds. This means that our hypothetical client does not have a compelling case for switching from repos to bonds right now.

Furthermore, with central banks around the world now contemplating some degree of tapering off after providing liquidity to financial markets for the past 18 months during the pandemic, and with interest rates now at historic lows, it is now more likely that rates will rise at least in the medium term. This possibility of rising interest rates is another reason for investors to invest in repos with shorter maturities so that when interest rates rise and their repo investment matures, they can reinvest at higher rates, whereas if the client had invested in the bond, they would either have to sell in a depressed bond market or hold until maturity at the lower yield.

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