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Corporate Bonds

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Introduction

Corporate bonds are loans issued by companies. Investors lend money to those companies by purchasing the bonds on which **a fixed rate of interest is paid for a fixed period** at the end of which the investor expects that their capital will be repaid. Companies issue such loans to fund future developments or investment (take-over) opportunities.

The amount of interest paid by the company will be based on the current level of interest rates and **the risk that the company might default on one or more interest payments** or go bust and not return the investor's capital.

The proportion of an investor's 'free assets' (ie those available for investment) that are held in fixed interest investments (ie gilts, index-linked gilts and corporate bonds) is **generally accepted as being too low for the majority of UK investors**.

Many investors seem to have portfolios that consist of cash deposits on the one hand and share portfolios on the other, with **little in between to bring stability to the investment process**.

When stock markets have shown good returns for a number of years, investors move some of their cash deposits into shares in the hope of making capital gains and **when markets fall investors sell their shares** and put what is left of their money back on deposit where it is 'safe'.

> "Anyway, you get the picture - deflation is now a very serious risk. And that's fantastic for good quality bonds, because you're locking into a fixed rate of interest which could soon be extremely attractive."
>
> From *The Bond Vigilantes blog written by the M&G bonds team* November 2008

Investment success

It is generally agreed that **the most important ingredient for investment success** is not the actual investment selection, or market timing, but **getting the asset allocation right**. That is, how much to invest in cash, gilts and other fixed interest bonds, property, equities and alternative investments.

Equities (ie stocks and shares and those investments directly linked to them) **exhibit the greatest volatility** and therefore pose the highest risk of loss, and by the same token, the highest potential reward.

To **reduce the risk of a portfolio** we can obviously include cash (ie deposit accounts and lower risk money market funds) and certain national savings products, but also guaranteed income bonds, fixed interest investments, commercial property and various alternative investments.

That is not to say that fixed interest investments and commercial property do not exhibit volatile characteristics at times but this will generally be of a different order than the volatility of equities.

What are bonds?

Unfortunately a number of investment products include the word 'bond' in their title and this can be quite confusing.

For example a 'Fixed Term Bond' offered by a building society is likely to be an investment in cash.

A 'Capital Investment Bond' offered by a life assurance company could be an investment purely into equities, although it may contain a fixed interest element.

When we use the word 'bonds' without any qualification **we generally refer to fixed interest investments**.

At its most basic, a bond is **a debt** owed by the borrower on which **a fixed rate of interest** (called a coupon) is paid until **a pre-determined redemption** (maturity) date, when the bond is repaid at face value (par).

The **basic ingredients of a bond** are therefore as follows:

- A bond is **a debt** owed by the borrower – in this context the borrower can be the UK government - if the investment is in 'gilts', or a commercial company, local authority or non-UK government - if the investment is in 'bonds'.
- A **fixed rate of interest** is paid on the bond. This is called the 'coupon'.
- The interest is paid until **a pre-determined maturity date**. This is called the 'redemption date'.
- At the redemption date the bond is **repaid at its face value**. This value is called 'par'.

Gilts and index-linked gilts offer the highest levels of capital security when held to their redemption dates.

Corporate bonds, as their name suggests, are issued by large companies in return for capital lent to the companies to assist them in their businesses. The level of capital security that such bonds offer at their redemption dates varies greatly with the size and security of the company offering the bond.

> "What's not to like about bond funds right now? Spreads are just extraordinary, you're being rewarded handsomely for risk, the Bank of England governor is talking about deflation rather than inflation, and interest rates are heading through the floor.
>
> Default is your only worry - although, admittedly, a rather large one. The daily news flow from the real economy is telling us that the unreality of recent months - when banks were collapsing but shopping malls and restaurants were bustling - is now over. The real economic pain is only just beginning.
>
> How many firms will go under? How many will default on bond payments? Will it be a recession or a depression? The great comfort for John Hamilton, manager of Jupiter's Corporate Bond fund, is that the market is already pricing in default rates equal to the Great Depression - and even the most gloomy and pessimistic are not expecting the 20-40% falls in output that characterised the 1930s."
>
> From *Bond markets yield incredible value* published by Patrick Collinson *The Guardian* Personal Finance Editor in *Fund Strategy* November 2008

The only practical way for most clients to invest in corporate bonds is to use a collective investment scheme such as a **unit trust**, **OEIC** (Open Ended Investment Company) or **ISA**.

The term Corporate Bond Fund is commonly used to describe a wider range of investments than simply UK corporate bonds and such funds can include other investments such as **Preference Shares** and **Convertibles** as well as European and indeed global bonds.

It is **very important for investors to know the range of bonds** that can be used by a manager in any particular bond fund.

The past performance of bonds

The Barclays Capital Equity & Gilt Study 2008 showed that **gilts have returned 3.3% pa in real terms (ie in excess of inflation) over 10 years**. Other figures for longer periods are 5.1% pa over 20 years, 2.4% pa over 50 years and 1.1% pa over 108 years. The figure for **corporate bonds** showed that **bonds have returned 4.2% pa in real terms over 10 years** and an impressive 7.9% pa over 20 years.

The 20 year figure is impressive because **equities**, supposedly the foremost engine of capital growth, **only managed 6.7% pa over the same period**. There are no figures for longer periods. Please note that the past is not necessarily a guide to future performance.

The risk to capital and income

We have seen that corporate bonds are issued by large companies in return for **capital lent to the companies** to assist them in their businesses. In return for the loan the company will offer **a fixed rate of interest** and **a fixed repayment date**. This is a similar procedure to the issue of gilts by the government. However, there is obviously **far more likelihood of a company defaulting** on its capital or interest repayments than the UK Government.

In view of this extra risk **the interest available from corporate bonds is normally higher than that from gilts**. This is borne out historically by the Barclays Capital Equity & Gilt Study where there has been an increased return of 2.8% pa over 20 years from corporate bonds over gilts.

In general there are **two main factors that will affect the value of your investment** in a corporate bond fund:

- as **interest rates** rise, yields on existing bonds start to look less attractive, so there is less demand and the price correspondingly falls. In such a scenario the value of your corporate bond fund will tend to fall especially if you are taking the income.

  Falling interest rates make the existing bonds relatively more attractive and hence the price rises. In this case you might find that there is some capital growth on your investment in excess of the income produced.

- higher **ratings** for the bonds imply superior financial strength and less risk of default. Price movements occur when bond issuers are re-rated by credit agencies.

  A higher rating will make the bond more attractive and so the price will generally rise while **a downgrade** will suggest a higher probability of default and therefore a lower price should follow.

  During a long bear market there is a flight to security in corporate bonds with bonds issued by 'weaker' companies seeing the face values of their bonds fall.

  As markets pick up **many of these 'weaker' companies have their credit risk re-rated** and holders of these bonds, typically held in the higher income bond funds, **can obtain capital growth on their investments**.

The importance of these two factors varies dependent upon the credit rating of the bond. **At the AAA end of the market** (ie the best credit rating that can be given to the bond) where the risks of default are very much less, bond prices will be **more affected by interest rate movement** and so react increasingly like gilts.

Conversely, the **non-investment grade bonds** (ie below BBB) will be more impacted by changing credit ratings and the overall financial viability of the company. In this way there is **more a correlation with the volatility shown by equities**.

Investing via an ISA

The advantage of investing into a corporate bond fund via an ISA is that the ISA manager is able to **reclaim the tax deducted at source on the interest payments** (ie the coupon) and will **pass on the gross amount to you** (or add it to your fund if the income is being accumulated).

A word about yields

There are two measures of prospective returns on corporate bonds, the **Income Yield** (also called running yield) and the **Redemption Yield**.

The Income Yield is a simple measure of **how much annual income a bond will provide** to its investor. For example, consider the ABC plc 7% 2016 corporate bond. The bond matures in 2016 at £100 (par). It has a coupon of 7% (ie £7 per year interest) and a current market price of £115. **The current income yield of the bond is therefore 6.09%** (ie 7% x 100/115).

The Redemption Yield takes into account the income that the investor will receive, the redemption date **and the ultimate capital loss/gain** at maturity.

The Redemption Yield assumes that the bond will be held to redemption, which in practice will often not be the case.

Among professional investors, the redemption yield is the preferred yardstick. In the previous example **the Redemption Yield takes account of the £15 loss in 8 years' time and has been calculated as 4.46%.**

It is not possible to use a Redemption Yield for a corporate bond fund because the fund will have no specific redemption date. In practice, therefore, most funds quote a Running Yield. This **overstates the potential return from a fund** when redeemable bond prices are standing above par.

A word about credit risk

Credit risk is **the probability that interest or capital will not be paid when it falls due**. It is the main difference between an investment in gilts and an investment in corporate bonds.

Credit risk is made up of two components, the Default Rate and the Recovery Rate. The **Default Rate is the proportion of bonds that miss a payment of capital or interest**. On global bonds it was 1.4% in 1997 and was 5.8% in 1999 (Moody's the rating agency). However, a bond that defaults does not automatically become worthless.

Defaults do not often result in a total loss for the investor. The Recovery Rate is a measure of the amount that an investor can recover from a defaulted bond. For much of the 1990s the average Recovery Rate for corporate bonds as around 50% of par value.

> "Since 1970, the highest incidence of default amongst issuers in the sterling investment grade bond market over any five-year period, was just under 2.5%. The average default rate over that period was less than 1%. In contrast, current yield spreads imply a default rate of 35%. That is, more than a third of issuers in the sterling investment grade bond market are, on the basis of current market pricing, expected to default over the coming five years. That seems, to us, highly unlikely."
>
> From *Extraordinary times; extraordinary valuations* published by Invesco Perpetual November 2008

Investors' look for the bond issue's credit risk **provided by one or more of the main credit rating agencies**: Standard & Poor's, Moody's and Fitch/IBCA.

Generally, bonds from a highly credit worthy company with a good history **will obtain an A++ or AAA rating**, with the grading then scaling down alphabetically through A, BBB, B, CCC and below.

As bond ratings have to be paid for by the issuer, many issues are not rated. Of the issues that are rated, **there is a major dividing line at BBB** (Baa3 - Moody's). Any company or bond rated AAA, AA, A or BBB is classified as 'investment grade'. Those rated **BB and below are considered 'high yield'** because their risk levels mean higher interest payments are needed to attract investors. History shows that once the investment grade threshold is crossed the default rises exponentially.

At the bottom of the scale, CCC and below, these bonds should be avoided by all but the most adventurous and experienced investors. They carry a default risk in excess of 50% and are **sometimes referred to as 'junk bonds'**.

Building a corporate bond portfolio

We have seen that investment grade bonds and high yield bonds react differently to market conditions. If you wish to have a portfolio of Corporate Bonds, therefore, **it is preferable to have a mix of both types of fund** as this should provide not only a higher income but a greater overall stability of capital.

It can be further shown that **including an equity income fund**, rather than increasing the risk to capital in the portfolio, **should actually reduce it over the longer term**.

Using an investment platform

The simplest way to invest into a range of Corporate Bond, Gilt and Equity Income Funds is to use an investment platform. With a minimum £1,000 investment into each fund, even a single £7,200 ISA can hold a balanced portfolio of such funds.

We use the **Nucleus Wrap** for clients with a total of more than £20,000 to invest (including existing investments which can be re-registered to Nucleus) and the **Cofunds Fund Supermarket** for small investments.

Risk Factors

- All investments carry an element of risk. Where past performance is mentioned please note that the past is not necessarily a guide to future performance.
- An investment into a unit trust, OEIC, ISA, or other collective investment scheme, is intended as a long-term investment. Both capital and income values may fall as well as rise and are not guaranteed. You may not get back the full amount you invested.
- These notes do not replace the full product specification that accompanies each investment recommendation. Each fund has its own objectives and risk factors. These are detailed in the Key Features document. Before you decide to invest in any fund you must read this document.
- The tax efficiency of any investment depends on individual circumstances and tax rates and laws may change in the future.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an investment into corporate bonds is suitable, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For personal advice

If you would like to discuss whether an investment into corporate bonds might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

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