

Corporate Bonds

Continuing economic and financial volatility has cemented in investors' minds the importance of diversification across asset classes. As interest rates have been driven down, and government gilt yields have fallen, investors seeking income or a higher rate of interest are increasingly turning to corporate bonds.

What is the bond market?

The bond market, also known as the debt, credit, or fixed income market, is a financial market where participants buy and sell debt, usually in the form of bonds ⁽¹⁾. As of 2006, the size of the global bond market was an estimated \$45 trillion with Corporate bonds accounting for \$15 trillion in issue (source: Merrill Lynch Bond Index Almanac). Since the mid-1990s, corporate bond markets have become an increasingly important source of financing for companies, even more so with the recent credit and liquidity crunches ⁽²⁾ which have caused banks to reduce their lending.

What is a Corporate Bond?

A 'corporate bond' is an 'IOU' issued by a company (corporation) rather than a government, typically with a maturity of greater than one year; anything less than that is often referred to as commercial paper ⁽³⁾. They are a way to raise money for projects and investment and are also known as credit. The issuance of a bond will often provide low cost finance, especially the case in recent years with low inflation, interest rates and good corporate stability. The low cost of the interest or coupon payments can be further reduced by the fact the payments are generally tax deductible. By issuing bonds, rather than equity, a company will also avoid diluting the equity in the company.

A company seeking to raise money issues corporate bonds. These will typically be bought by investors at what is known as "par", usually for 100p. Like equities, bonds can be bought and sold until maturity and values can fluctuate depending on supply and demand. Other external factors, such as interest rates, can also impact the price. The company commits to pay a coupon or rate of interest to the investor. This will generally be a fixed amount and is paid annually or semi-annually. After a defined period, set at outset, the bond is repaid by the company. Bonds will typically redeem at par or 100p irrespective of how the market price has fluctuated before maturity.

How are Corporate Bonds rated and by whom?

Independent ratings agencies are responsible for researching companies and supplying 'grades' or 'ratings' to companies' debt (bond issues). The most readily recognised ratings agencies are Standard & Poor's, Moody's and Fitch Ratings.

There are two main subdivisions of corporate bonds depending on their ‘credit rating’, which indicates to investors the level of risk associated with the bond.

Investment Grade Bonds - With investment grade bonds it is assumed that the chance of non-repayment or default is low due to the issuing company having a comparatively stable financial position. As a result of the increased stability, the income or coupons offered are usually lower than those from sub or non-investment grade.

Sub-Investment Grade Bonds - High yielding, sub-investment grade bonds are higher risk investments. They are sometimes referred to as junk bonds. These tend to be issued by less financially secure companies or those without a proven track record. The default rate of these bonds is expected to be higher than investment grade corporate bonds.

What are the ratings?

The ratings depend on how the credit rating agencies view the financial standing of the company issuing the bond, its ability to continue to make payments to its bond holders in the future and what protection the bondholder has should the company face financial difficulties.

Bond Credit Quality Ratings

Credit Risk	Moody's*	Standard & Poor's**	Fitch Ratings**
Investment grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not investment grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

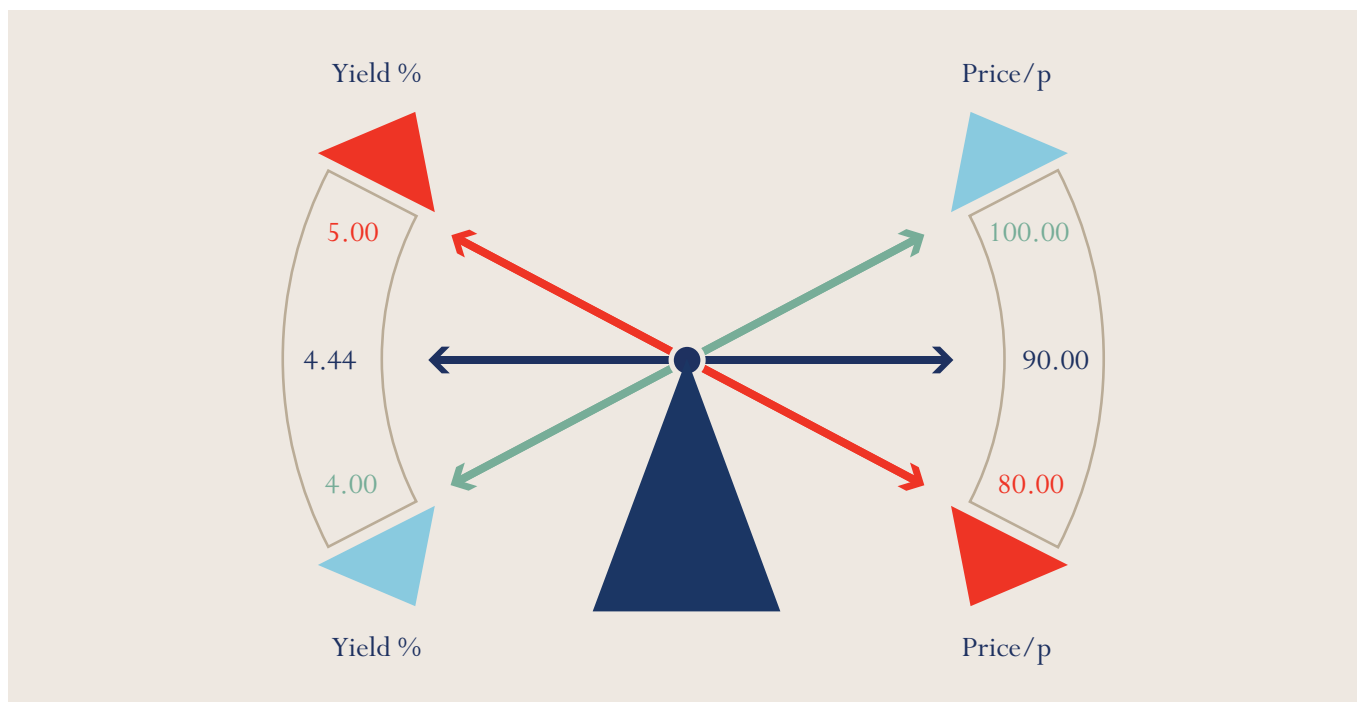
*The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2 or 3 to show relative standing within the category.

**The ratings from AA to CC by Standard & Poor's and Fitch Ratings may be modified by the addition of a plus or minus sign to show relative standing within the category.

How are returns measured?

The income generated from a bond is referred to as the yield. There are typically two yields to indicate the return the bond provides to an investor ⁽⁴⁾;

Income Yield - also called the interest yield or running yield, is a simple measure of how much annual income a bond will provide to the investor. The diagram below shows the relationship between yield and the price of a bond.



In this example, the bond yields 4.00% based on its par value of 100p, i.e. 4p. If the market value of the bond drops to 90p it still pays out 4p. This means any purchaser at this price will receive a yield of 4.44%. If the price of the bond drops further the yield will increase. Conversely, as the price of a bond increases the yield decreases.

Redemption Yield - takes account of both the income received until maturity and the capital gain or loss when the bond is redeemed. If a bond has been purchased at a market price higher than the par value at redemption then there will be a capital loss. This would mean the redemption yield will be less than the income yield. Depending on market conditions, there can be a substantial difference between the redemption yield and the income yield.

What impacts bond valuations?

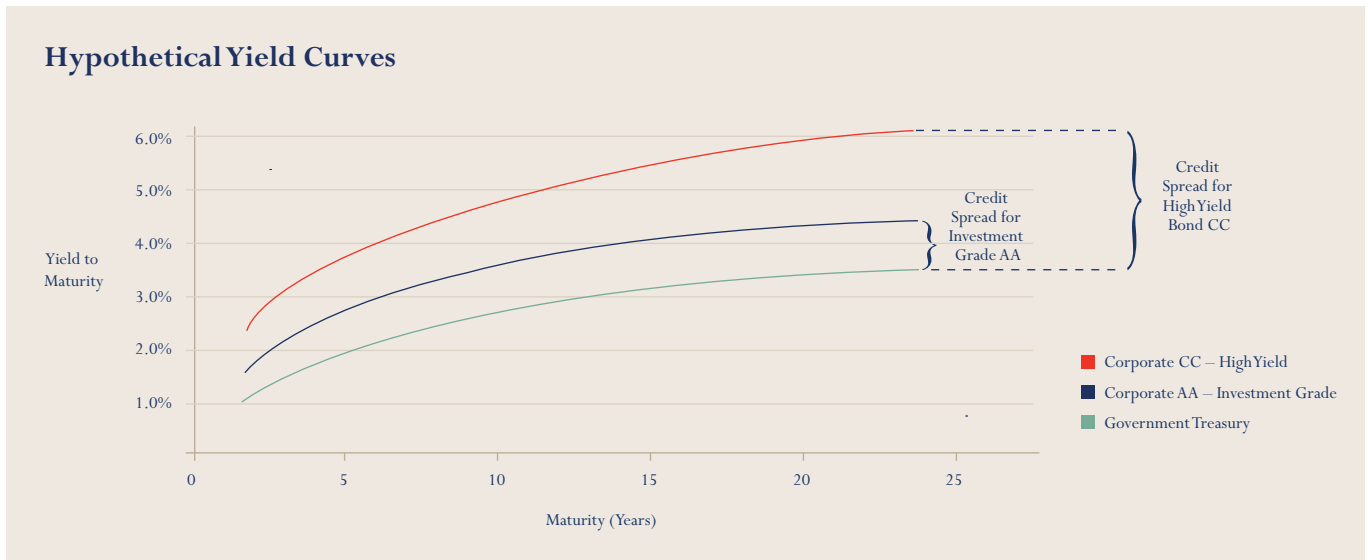
Interest rates – the relationship between interest rates and corporate bond prices is usually negative, i.e. corporate bond prices fall when interest rates rise. A rising interest rate makes the present value of the future coupon payments less attractive in comparison and investors may sell bonds, in order to move their monies. Any new issues of bonds must raise their yields in order to attract investors so older issues with lower yields become less popular. Conversely, declining interest rates cause investors to seek higher yields from bonds, increasing the price.

Inflation – Similar to interest rates, the relationship between inflation and corporate bond prices is usually negative. A high rate of inflation reduces the value of future coupons or redemption value causing investors to seek alternative investments. Inflation and interest rates are often linked; predominantly because interest rates are commonly used by central banks as a way of moderating inflation.

Like all asset classes, valuations can be impacted by a wide range of factors, both general economic and financial, as well as specific to the issuing company. The performance of other asset classes can also impact valuations as they attract investors away from or to bonds.

What are yield curves and spreads?

A yield curve illustrates the 'yield to maturity' of a range of similarly rated bonds with different periods to maturity. In the yield curve chart below bonds issued with longer maturity will typically offer higher yields to compensate for the additional risk of time.



The illustrated yield curves also demonstrate that credit spreads (yield on the type of bond illustrated minus the yield on government gilts of an equivalent maturity) are typically higher for riskier debt.

Why do investors buy Corporate Bonds?

Companies typically offer higher yields than comparable maturity government bonds, bearing in mind the higher level of risk. Since corporate bonds can be bought and sold, supply and demand can also generate capital appreciation in addition to income payments.

Similar to equities corporate bonds provide the opportunity to choose from a variety of sectors, structures and credit-quality characteristics to meet investment objectives. At the same time should an investor need to sell a bond before it reaches maturity, in most instances it can be easily and quickly sold because of the size and liquidity of the market. Most importantly for those seeking an income coupon payments and final redemption payments are usually fixed; this means there is a certainty about both the amount and timing of the income an investor will receive.

References

1. Bonds are explained in Investment Bulletin 6 – Fixed Income
2. The credit crunch and associated terminology is explained in 'Investment Bulletin 5 – The Credit Crunch'
3. Commercial paper is explained in Investment Bulletin 7 – Cash and Money Markets
4. Yields and their calculation are explained in Investment Bulletin 6 – Fixed Income.

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