

understanding corporate bonds

INTRODUCTION

When companies want to expand operations or fund new business ventures, they often turn to the corporate bond market to borrow money from investors. A company seeking to borrow money in the bond market determines how much it would like to borrow and then issues a bond in that amount. Investors that buy corporate bonds are effectively lending money to the company that issued the bonds, according to the terms established in the bond offering.

SIZE OF THE CORPORATE BOND MARKET

Over the years the corporate bond market has attracted many investors seeking higher yields than those offered by government bonds and other sectors of the global bond market. According to Merrill Lynch data, corporate bonds accounted for about 18 per cent of bonds outstanding in the world in 2006, while the market for government bonds comprised about 53 per cent of the total.

INVESTMENT-GRADE VS. SPECULATIVE-GRADE BONDS

Corporate bonds have a wide range of ratings reflecting the fact that the financial health of issuers can vary widely. Corporate bonds fall into two broad credit classifications: investment-grade and speculative-grade (or high yield) bonds.

Speculative-grade bonds are issued by companies perceived to have a lower level of credit quality compared to more highly rated, investment-grade, companies. Historically, speculative-grade bonds were issued by companies that were newer, were in a particularly competitive or volatile sector or had troubling fundamentals. Today, there are also many companies whose businesses are designed to operate with the degree of leverage traditionally associated with speculative-grade companies. While a speculative-grade credit rating indicates a higher default probability, the higher risk of these bonds is often compensated

for by higher interest payments or yields. Ratings can be downgraded if the credit quality of the issuer deteriorates, or upgraded if fundamentals improve.

CHARACTERISTICS OF CORPORATE BONDS

Unlike equities, ownership of corporate bonds does not signify an ownership interest in the company that has issued the bond. Instead the company pays the creditor who purchased the bond a rate of (taxable)

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interest over a period of time, as well as repayment of the principal at the maturity date established at the time of the bond's issue.

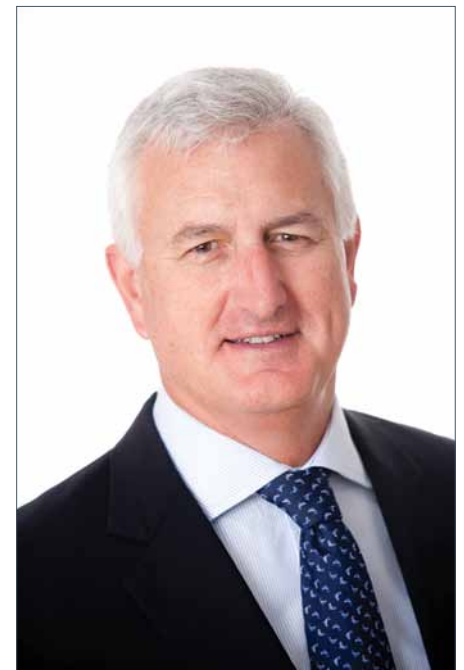
While some corporate bonds have redemption or call features that can affect the maturity date, most are loosely categorised into the following maturity ranges:

- Short-term notes (with maturities of up to five years)
- Medium-term notes (with maturities ranging between five and 12 years)

- Long-term bonds (with maturities greater than 12 years)

Corporate bonds share several other characteristics, including:

- **Diversification:** Corporate bonds offer the opportunity to invest in a variety of economic sectors. Within the spectrum of corporate bonds there is a wide divergence of risk and potential yield. Corporate bonds can improve the diversification to an equity portfolio as well as diversify a fixed interest portfolio of government bonds or other fixed interest securities.
- **Income:** Corporate bonds have the potential to provide an income stream. Most corporate bonds pay on a fixed semi-annual rate schedule. One exception is zero-coupon bonds that do not pay out interest payments but are sold at a deep discount and then redeemed for full face value at maturity. Another exception is floating-rate bonds that have fluctu-



This article by Patrick Bennett (above), Head of Research.

ating interest rates tied to money markets or Treasuries. These tend to have lower yields than fixed-rate securities of a comparable maturity but also less fluctuation in principal value.

- **Yields:** Corporate bonds tend to provide higher yields than government bonds of comparable maturity.
- **Liquidity:** High grade corporate bonds are often more liquid than other securities and can be sold at any time prior to maturity in a large and active secondary trading market.

THE BASICS OF CORPORATE BOND PRICING

The price of a corporate bond is influenced by several factors including: the length of the maturity, the credit rating of the company issuing the bond and the general level of interest rates.

The yield of a corporate bond fluctuates to reflect changes in the price of the bond caused by shifts in interest rates and the markets' perception of the issuer's credit quality.

Corporate bonds typically have more credit risk and higher yields than do government issues of similar maturities. This difference creates the spread between corporate bonds and government bonds, where the corporate bond investor is rewarded with extra yield by taking on greater risk.

The credit spread is a determining factor affecting the price of the bond and is measured as the difference between the yield of a corporate and government bond at each point of maturity along the yield curve.

CONCLUSION

Corporate bonds can broaden a risk profile and diversify a portfolio of equities and/or government bonds depending on the economic environment, the credit rating of the bond issuer and the level of risk tolerance sought. In addition to diversification, they offer the potential for steady income and attractive yields, liquidity and a ratings system that potentially guides investment opportunities.

Acknowledgements: Source: PIMCO 2007



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