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Investment Basics

What are Corporate Bonds and What Potential Benefits do They Offer?

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 determines how much it would like to borrow and then issues a bond in that amount; investors that buy that bond are effectively lending money to the company according to the terms established in the bond offering.

Characteristics of corporate bonds

Over the years, the corporate bond market has attracted many investors seeking higher yields than those offered by government bonds. In general, corporates are the second largest sector in the bond market after government 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 investor a rate of (taxable) interest over a period of time and repays 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 categorized 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 vital characteristics, including:

- **Diversification:** Corporates offer the opportunity to invest in a variety of economic sectors. Within the broad spectrum of corporates there is a wide divergence of risk and potential yield. Corporate bonds can add diversification to an equity portfolio as well as diversify a fixed income portfolio of government bonds or other fixed income securities.

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- **Steady income:** Corporates have the potential to provide a steady income. Most corporate bonds pay on a fixed semiannual schedule. One exception is zero-coupon bonds, which do not pay interest but are sold at a deep discount and then redeemed for full face value at maturity. Another exception is floating-rate bonds that have fluctuating interest rates tied to money markets, the London Interbank Offered Rate (LIBOR) or U.S. Treasury bonds. These tend to have lower yields than fixed-rate securities of comparable maturities but also less fluctuation in principal value.
- **Attractive yields:** Corporates tend to provide higher yields than comparable maturity government bonds.
- **Liquidity:** 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.
- **Ratings:** Credit agencies such as Moody's Investors Service and Standard & Poor's provide independent analysis of most corporate bond issuers, grading each issuer according to its creditworthiness. Corporate bond issuers with lower credit ratings tend to pay higher interest rates on their corporate bonds (see below for more).

The corporate dividing line: 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. The investment-grade category has four rating grades while the speculative-grade category is comprised of six rating grades. Historically, banks were only allowed to invest in bonds in the four highest categories (hence the term "investment grade") while the companies with the bottom six ratings were generally considered too risky and speculative for financial institutions.

	MOODY'S	STANDARD & POOR'S
INVESTMENT GRADE		
Highest quality (Best quality, smallest degree of investment risk)	Aaa	AAA
High quality (Often called high-grade bonds)	Aa	AA
Upper medium grade (Many favorable investment attributes)	A	A
Medium grade (Neither highly protected nor poorly secured)	Baa	BBB
SPECULATIVE GRADE		
Somewhat speculative (Have speculative elements)	Ba	BB
Speculative (Generally lack characteristics of a desirable investment)	B	B
Highly speculative (Bonds of poor standing)	Caa	CC
Most speculative (Poor prospects)	Ca	CC
Imminent default (Extremely poor prospects)	C	C
Default	C	D

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, these bonds typically compensate investors for the higher risk by paying higher interest rates, or yields. Credit ratings can be downgraded if the credit quality of the issuer deteriorates or upgraded if fundamentals improve.

Fallen angels, rising stars and split ratings

"Fallen angel" is a term that describes an investment-grade company that has fallen on hard times and has subsequently had its debt downgraded to speculative grade. "Rising star" refers to a company whose bond rating has been increased by a credit agency due to an improvement in the credit quality of the issuer. Since the credit agencies' ratings are subjective, there are also times when they do not concur on the rating – an occurrence known as a "split rating." Fallen angels, rising stars and split ratings may all present opportunities for investors to add additional yield by assuming greater risk due to the potential volatility of their ratings.

The basics of corporate bond pricing

The price of a corporate bond is influenced by several factors, including 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. Most corporates typically have more credit risk and higher yields than government bonds of similar maturities. This divergence creates a credit spread between corporates and government bonds, so that the corporate bond investor earns extra yield by taking on greater risk. The credit spread affects the price of the bond and can be graphically plotted and 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 offer potential benefits

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 investor's level of risk tolerance. In addition, they may offer investors the potential for steady income and attractive yields.

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