A KMI report

Investment grade corporate bonds

Investment grade corporate bonds (also known as **high grade corporate bonds**) are the best-quality corporate bonds, as determined by rating agencies such as Moody's. They are debt securities, issued and redeemed by the strongest companies.

Technically, a bond is considered investment grade if its credit rating is judged as BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's.

Corporate bonds are issued in blocks of say £1,000 in par value (or $1,000, or whatever your currency is). You buy them either at issue or on the stock market.

Provided all goes well with the issuing company, you get a regular interest payment up until a pre-determined date when the bond is redeemed, whereupon the nominal value of the bond is returned to you and the bond ceases trading.

Your total return is determined by the price you paid, and the bond's interest rate.

Corporate bonds are more secure than shares

A company must pay the interest due on bonds whether or not it makes a profit. This is in contrast to dividends, which are paid at the directors' discretion.

Corporate bond holders also rank ahead of equities in the company's capital structure.

This means corporate bonds are less risky than the shares of the same company. This is especially true if you buy the corporate bonds when they are first issued and hold until they are redeemed. (Between those two points the bond price fluctuates, which could mean a better or worse return for you the buyer).

In return for this lower risk, the return is lower than for shares; the **fixed interest rate payable** by normal corporate bonds does not change over time, unlike share dividends which generally go up.

Note that although investment grade bonds are the safest corporate bonds, they can and do default, since even well-known companies can go bust. They are therefore riskier than government bonds, which in the UK and US have never defaulted.

The extra interest paid for this extra risk over government bonds is currently between 2.5-5%, per annum, which is attractive

'Domestic' investment grade corporate bonds are bonds that are issued by companies operating in your own country and currency.

You can buy overseas corporate bonds if you want, but then you're very exposed to short-term currency risk, too.

Very high-yield or junk bonds

These are corporate bonds deemed by the ratings agencies to be below investment grade. They may have been issued by weaker companies, or they may be the bonds of formerly strong companies that have fallen on hard times.

As the name 'high-yield' suggests, the interest rate on high-yield bonds is much higher than on investment grade corporate bonds or government bonds. This is to make up for the far greater risk; high-yield bonds frequently default.

Generally, high-yield bonds are bought by investors speculating that the bonds will be favourably re-rated and so will rise in price.

It is sometimes fashionable (invariably after good spell of performance) to suggest high-yield bonds aren't that risky as long as you hold a basket of them. But a bad patch will soon see them labelled by the term 'junk' once more.

Clearly the time to buy junk bonds is when their yields are extraordinarily high versus investment grade corporate and government bonds. Unfortunately, those times tend to be when people least feel like investing in them, due to the turbulent conditions.

Due to the fear in the markets, 2009 may well prove retrospectively to be just such a time. On the other hand, in a severe recession companies will go bust in droves. Capital losses from defaulting bonds could then overwhelm the extra interest you get on your junk bond fund, leading to a bad investment result.

But even high grade corporate bonds can and do default (or get downgraded), so as ever it's all about the price you pay and the potential return.

Just as governments issue bonds to finance public spending, so companies issue bonds to raise money to invest in their business.

For companies, corporate bonds provide an alternative to raising money by issuing shares. For private investors, corporate bonds offer the opportunity to buy a fixed income in exchange for an investment of capital.

All types of corporate bonds share common traits; corporate bonds have a nominal value, an interest rate, and a stated redemption date:

- The **nominal value** (or principal) is the initial price paid for the bonds
- The **interest rate** (or coupon) states the income you'll be regularly paid for owning the bond (it's usually fixed for the life of the bond)
- The **redemption date** is the specific date when the company will repay you the nominal value of your bonds

Corporate bonds are traded on the stock market, just like shares. This means the price of a corporate bond fluctuates between the issue date and the redemption date.

The interest rate paid by a bond at a particular price is called the **current yield.** It's also known as the income, earnings, flat, running or interest yield, and is expressed as a percentage.

When the price of a bond rises, **the current yield falls**, because you must pay more for the same amount of income from the bond.

When the price of a bond falls, **the current yield rises**, since you pay less money to buy the same amount of income from the bond.

Note that commentators usually talk about bond yields rising and falling, and the consequences for prices, rather than the other way around, since it's the yield and its relation to the wider interest rate environment that drives bond valuations. The reality is that bonds are being bought and sold at changing prices, so changing the yield. But it's the yield that drives the price changes.

If you **hold a bond to maturity**, you'll get the stated nominal value returned to you. This nominal value may be higher or lower than the price you pay in the market for a bond, depending on whether you buy the bond at a discount or a premium.

The **redemption yield** indicates the total return due from holding a bond to maturity; it incorporates capital gains or losses that will be due at redemption, as well as the income due from the bond coupon.

There are three main things that drive changes in a corporate bond's yield and so its price:

1. The closeness to the redemption date
2. The interest rate environment
3. The perceived risk of the bond defaulting

Let's consider each factor in turn.

Factor 1. Closeness to redemption date

The closer a bond is to the date at which it will be redeemed for its nominal value by the issuing company, the likelier it is to be priced close to or at that value, since there's otherwise a quick capital gain (or loss) to be made by holding.

Factor 2. The interest rate environment

As interest rates rise and fall, the risk-free rate available from longer-term government bonds also rises and falls. This has consequences for corporate bond yields, since a government bond at a particular yield will always be more attractive than a corporate bond offering the same yield (see the next point). Therefore the yield and price of corporate bonds change as the risk-free rate changes.

Factor 3. The chances of the bond defaulting

If you can get a 4% yield from a government bond with a tiny risk of default, you wouldn't accept 4% from a riskier and less liquid corporate bond. Investors will demand a greater return for the risks of holding the corporate bond in the form of a higher yield, which will reduce the corporate bond's price.

This risk is called the 'credit risk', and it is usually determined by the market's assessment of the issuing company's fundamentals. If investors believe there's a greater chance of a specific corporate bond defaulting than is reflected in its market price, they will demand greater returns for holding it – in other words a higher yield / lower price.

Credit risk is the main difference between investing in government and corporate bonds. With government bonds you can be extremely sure of receiving the interest you're due and having your capital returned. But corporate bonds can and do occasionally default.

This difference between the risk-free rate and the yield on a corporate bond is known as the yield spread.

How much more yield investors demand from a basket of corporate bonds versus a basket of government bonds is typically influenced by economic and market cycles. At the time of writing, fear in the markets has led to a wide spread between government bonds and even highly-rated corporate bonds. In contrast, in a bull market spreads tend to narrow, as investors chase yield and so bid up prices for income-producing assets.