



November 2008

A guide to corporate bonds

What is a bond?

A bond is effectively a loan made by one party (an investor) to another (such as a government, company or other institution) to meet the financing requirements of the latter. In addition to repaying the capital (the 'principal') of the loan at the end of the bond's life ('maturity'), the bond issuer agrees also to pay the lender a certain rate of interest in the form of 'coupons' at specified intervals (usually annually or semi-annually) over the life of the bond. Unless the issuer defaults (fails to repay interest or principal when due), bond investors receive a known set of future cash flows; if investors hold a bond to maturity, they will receive regular coupons and the return of their capital. Between issuance and maturity, bonds are traded between investors on secondary markets.

What is a corporate bond?

A corporate bond, as its name suggests, is a bond issued by a company which requires funding. Corporate bonds are issued with a set of contractual terms and conditions (known as 'covenants') attached to them, which limit or require certain actions on the part of the issuer, including the payment of a coupon.

Corporate bonds are often attractive to companies as alternatives to short-term bank loans because the issuing company is not required to repay the capital value of the loan until maturity of the bond. Compared with a short-term loan, the issuance of a bond may therefore improve a company's debt-maturity profile and reduce its so-called 'refinancing risk'.

How are corporate bond values determined?

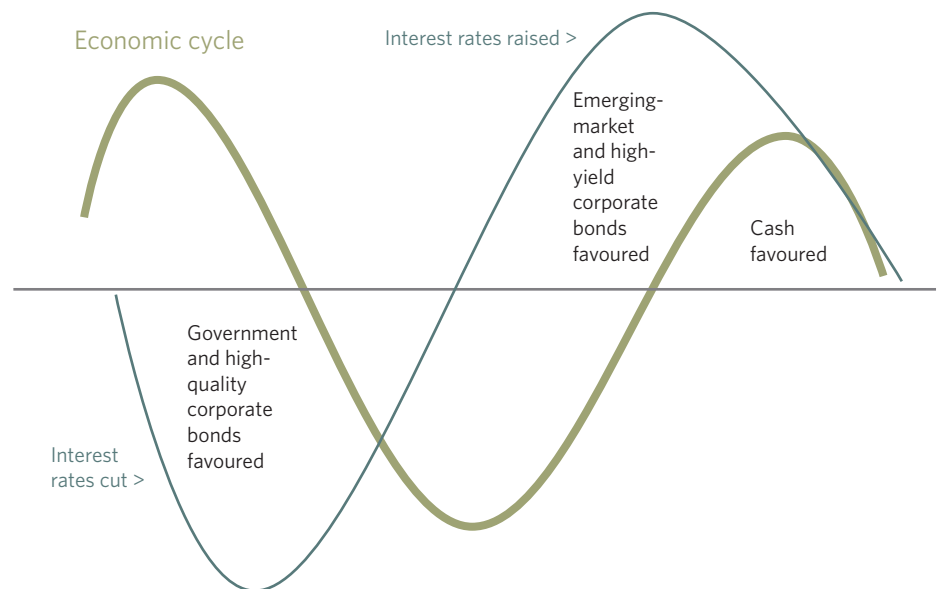
The value of a corporate bond can be expressed either in terms of price or in terms of yield. As the price of a bond rises, its yield (which equates to the level of its coupon as a proportion of its price) falls, and vice versa. A number of factors determine the value of a bond, among them being the credit risk associated with the bond issuer, the levels of interest rates and inflation, prevailing 'default' rates and market liquidity.

In general, corporate bond prices will rise in response to:

- lower credit risk
- lower interest rates
- lower inflation
- improving market liquidity

However, different types of bonds are affected in different ways by some of the above factors. The chart below depicts the typical fortunes of different bonds amid changes in economic conditions.

ECONOMIC WAVE



Source: Newton



Credit risk is usually expressed as a yield 'spread' over a similarly dated government bond. It is the additional yield offered to investors to compensate for the greater risk that a company (compared with a government) will fail to meet its obligations to bond holders, and it represents the expectation of higher risk and a higher return from a corporate bond than from a government equivalent.

Default occurs when a company fails to meet its obligation to ensure timely payment of either principal (the capital value of a corporate bond at maturity) or of interest. Unlike when a company fails to pay a dividend to its equity holders, a default on corporate bond commitments usually leads to the taking of control of a company by that company's creditors (including bond holders).

Market 'liquidity' is an important factor in the setting of corporate bond prices. Spreads tend to widen during periods of worsening liquidity in order to compensate investors not simply for credit risk, but also for the reduced likelihood that the bond issuer will be able to refinance.

How is corporate bond risk measured?

The key risk to a corporate bond investor is the risk that the issuing company will either fail to pay the coupons due on the bond or that it will not repay the capital of the loan at maturity. This risk is measured by agencies, such as Standard & Poor's and Moody's, which provide ratings of the riskiness of corporate bonds. Changes in a bond's rating can affect the price of that bond materially.

Corporate bond ratings range from 'AAA' (high-quality) to 'D' (bonds which are in default as a result of the non-payment of principal and/or interest). Bonds rated from 'AAA' to 'BBB' are known collectively as 'investment-grade' bonds and are deemed to be safer than 'non-investment-grade' bonds, which are rated from 'BB' to 'D'. There is a much greater likelihood that issuers of non-investment-grade bonds will fail to repay their debt than of default by (higher-quality) investment-grade companies.

The credit-rating agencies decide a bond's rating on the basis of their review of the issuing company's financial and

non-financial standing (for example, its competitive position, the serviceability of its outstanding debt and the outlook for the growth of its sales and profits). The agencies also take into account the prevailing state of the economy.

Investment grade versus non-investment grade

Non-investment-grade bonds are sometimes referred to as 'high-yield' or 'speculative-grade' bonds or, less favourably, as 'junk' bonds. Credit-rating agencies consider that there is a greater likelihood that the issuers of such bonds (rather than the issuers of investment-grade bonds) will fail to repay their debt. Non-investment-grade bonds offer higher coupons (and trade on higher yields) than investment-grade issues to compensate for their greater risk. The chart right illustrates the historic default rates of speculative-grade bonds.

Investment-grade bonds are usually highly correlated with government bonds, but the greater vulnerability of lower-quality bonds to changes in economic conditions means that non-investment-grade bonds are more highly correlated with equities.



How do corporate bonds compare with government bonds?

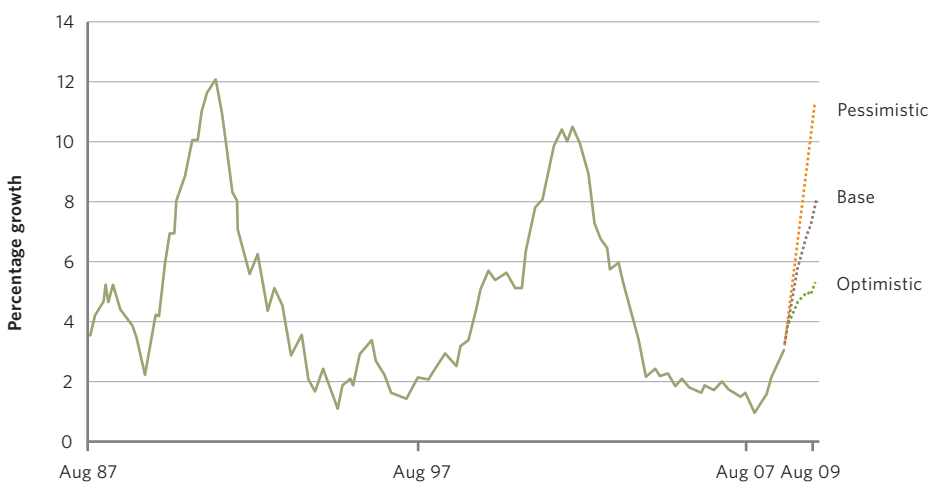
Investment in corporate bonds is riskier than investment in government bonds because it entails reliance upon a company rather than a government to repay debt. However, corporate bonds generally provide a higher level of income to compensate for this greater risk.

How do corporate bonds compare with equities?

Compared with shareholders in a company, corporate bond holders have important advantages of priority, protection and predictability in holding bonds rather than equities. Companies are obliged contractually to pay coupons to bond holders before they reward shareholders via dividend payments. Bond holders are also entitled at maturity

to repayment of their full principal investment. The coupon and principal on a bond are fixed (in contrast with the dividend on an equity), affording corporate bond holders thereby a predictable cash flow. Equities, by comparison, can be regarded as being akin to subordinated, perpetual bonds with variable and discretionary coupons. Furthermore, should a company's fortunes deteriorate, bond holders are protected to some extent by the seniority of bonds over equities in a company's capital structure; bond holders' capital is safer therefore than that of shareholders. In the extreme event of liquidation, shareholders will not receive any payment until (prior-ranking) bond holders have been repaid in full. In short, the comparison between the risk and reward characteristics of the capital invested respectively in corporate bonds and equities can be summarised as follows. Equities have unlimited upside and significant downside, whereas corporate bonds have limited upside and limited downside (making them less volatile than equities). In theory, therefore, corporate bonds should have a lower risk premium than that inherent in equities; in other words, corporate bonds should provide less opportunity than equities for capital appreciation.

DEFAULT RATES OF SPECULATIVE-GRADE BONDS



Source: Moody's

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