



Understanding Corporate Bonds

A few basics

If a company wants to raise money without asking the bank for a loan, it has two main options: issuing shares or issuing bonds that investors can buy.

A corporate bond – a bond issued by a company – is a loan the company takes out from investors instead of a bank. By buying (investing in) a bond, you lend money to the company, who will pay interest to you on a regular basis (this payment is called the coupon) until they pay back the full borrowed amount at the end (the maturity date).

Ratings indicate the broad level of risk of the investment

In a similar way to individual consumer's credit scores, companies' credit worthiness is rated by independent agencies. If you lend money to a company with a high rating, it means the chances of them being able to pay it all back are high, so it is a relatively safe way for you to get steady income through the coupons.

To attract investors willing to buy their bonds, the lower-rated companies (those that have a higher risk of not being able to pay everything back) generally pay a higher coupon than those with a higher rating. With the help of a financial advisor, it is up to you as an investor to decide what kind of bond you want to buy; in a trade-off between how much risk you are willing to take and how much money you want the coupon to pay out. Ratings go from AAA/Aaa¹ at the very top, down through to "junk" (CCC and lower).

Bonds with a rating ranging from AAA/Aaa to BBB/Baa are called "investment grade", while bonds with any lower rating are called "high yield"/"junk" (or sub-investment grade) since they pay higher coupons because of the bigger risk they present.

How does the risk of corporate bonds compare to other investments?

Compared with company shares (equities), corporate bonds are generally considered a lower risk because their price depends on more stable drivers than the price of shares: namely the coupon, interest rates and the company's rating (rather than the constantly moving business outlook of the company).

Additionally, in contrast to equities, bonds have a set date when they repay the money they initially borrowed, and that time horizon gives another element of stability. Also, in the worst case scenario of the company going bankrupt, bondholders are paid back before shareholders (provided there is enough company money left to do so).

On the other hand, corporate bonds are considered a higher risk than government bonds because - at least in the developed world – the likelihood of governments not being able to pay back their loans is generally considered to be remote.

¹The three main credit rating agencies, Standard & Poor's (S&P), Fitch and Moody's have subtle differences in their rating designations. Here in the text they are given as "[S&P, Fitch] / [Moody's]".

A few definitions



Issuer

The company that creates the bonds by borrowing money from investors against the regular payment of a coupon, until a given date at which it will pay back the full amount borrowed.



Coupon

The interest paid to bondholders. This is a set amount, paid out at regular, pre-set intervals. It is paid to investors in addition to the full reimbursement of the capital at the end.



Maturity date

The date at which the company will pay back the money ("capital") in full to investors.



Default

When a company cannot pay back its loan or misses an interest payment.



What is the yield of a bond?

In layman's terms, the yield is the interest you receive from your bond investment for the price you paid. It is a straightforward way to compare the value for money of different bonds at a given date.

The yield is generally expressed as a percentage. At any point in time, it is equal to: $(\text{coupon payment} / \text{bond price}) \times 100\%$.

For example, a bond priced £1,000 and paying a £100 coupon yields $(£100/£1,000) \times 100\% = 10\%$.

However, if on the bond market the average yield for similar types of bonds goes up to 12.5%, then to be competitive, this particular bond will need to be sold at a cheaper price, namely £800 instead of £1,000. Because the coupon amount is determined when the bond is issued and can not be changed throughout the life of a bond, it is the price of the bond that has to adjust: $(£100/£800) \times 100\% = 12.5\%$.

The other way around, if the average yield for similar bonds goes down to 8.33%, then this bond can be sold at a higher price and still provide the same value for money. It can be sold at £1,200 and provide the same yield as other similar bonds: $(£100/£1,200) \times 100\% = 8.33\%$. Therefore, the coupon payment would not be affected.

What is the credit spread?

The credit spread is the difference in yield between two bonds that have a different credit quality but a similar maturity. Corporate bonds typically yield more than government bonds to compensate for higher risk and that difference in yield is the credit spread. The credit spread can fluctuate over time as it is driven by different risk factors. Interestingly, the credit spread can move independently of interest rates, mitigating the effect that a change in interest rates may have on the price of a corporate bond.

For example, in a growing economy, governments tend to raise interest rates, which in theory should make corporate bond prices fall. However, better economic growth also makes it more unlikely for companies to default on their debts, which in turn lowers the risks associated with

corporate bonds and leads to narrower spreads. This means that because the risk is lower, investors don't need to get paid as much for holding the bonds.

On the flip side, investors should be wary of corporate bonds with very narrow spreads because if the economy starts to waver, the default risk of the company can sometimes increase quite quickly, leading to a widening of credit spreads and a fall in corporate bond prices. This can happen even if the government lowers interest rates to support the economy.

The impact of the maturity date

As explained above, the maturity date of a bond is its lifespan, i.e. the time between its issuance and its final reimbursement.

As we have seen, bonds are impacted by changes in the interest rate. A bond's interest rates sensitivity is linked to its maturity: the longer the maturity of a bond is, the more sensitive it is to changes in the interest rate.

As always with investments, each investor must find the right balance for them between taking a certain level of risk and receiving a certain level of return. Maturity, interest rate movements, and different companies' credit-worthiness will all impact the potential performance of the investment in a corporate bond.

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