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INTRODUCTION TO:
Corporate Bonds

CORPORATE BONDS

Definition:

Corporate Bonds represent debt certificates issued by a corporation to raise funds for various business purposes. Corporate Bond Holders are creditors of the corporation issuing the bond. Holders receive regular interest payments (usually semi-annually) at a fixed interest rate. If bankruptcy is declared, bond holders receive payments before preferred and common stockholders.

RISKS

- **Default Risk:** A company may not be able to pay interest or principal on a bond issue.
- **Interest Rate Risk:** If interest rates rise, new issues of bonds of similar quality become more attractive, lowering the price of previously issued bonds as they pay relatively less interest for a similar level of risk.
- **Call Risk:** For callable bonds, a corporation may buy back a series of bonds when interest rates fall. The investor would have lower interest rates available if seeking to invest the funds.
- **Secondary Market Risk:** Bonds traded on the secondary market are difficult to track and understand due to the limited amount available. This can create discrepancies in their pricing, thus increasing the investor's risk. It is important to thoroughly research the bond before settling on a price.

REASONS TO INVEST

Income: Corporate bonds are designed to pay regular interest to the holder.

Safety: A bond holder receives interest and principal payments unless the company is in default (unlike stock dividends, which can be irregular).

Capital Appreciation: Holders of a bond can make gains by selling the bond at a higher price in the market prior to maturity. This is generally not a primary reason to invest in bonds as other products are generally more suitable for capital appreciation in the market and provide greater upside potential.

FEATURES

Callable Bonds: Gives the company the option to buy back (call) the bonds at a certain time prior to maturity.

Convertible Bonds: Allows the holder to convert the bond into a fixed number of shares of stock. The holder of a convertible bond has the opportunity to make gains if the company's stock appreciates in value.

Put (Tender) Options: Allows the bond holder to sell (put) the bond back to the company at a specific time period and price.

Types of CORPORATE BONDS

1 SECURED

Backed by the specific assets of a company (i.e. equipment held as collateral to back the bond). Assets are sold to cover redemtion payment if the company cannot otherwise make the payment.

2 DEBENTURES (UNSECURED)

Backed by the good faith and credit of the issuer. No specific assets are held as collateral for the bond payments.

3 GUARANTEED

Bonds are guaranteed by another party (i.e. a parent company).

Valuation:

Once issued, bonds trade in the secondary market. The price of a bond is determined by:

- Rating (i.e. S&P and Moodys)
- Interest Rates
- Amount of time until maturity
- Corporation/Industry
- Other features (i.e. a convertible bond generally costs more than a nonconvertible bond due to the added benefit of capital gains for the holder if the stock increases in value).

Bond Ratings: Rating Agencies use a variety of factors to determine the credit worthiness of a bond issue. Ratings range from investment grade (high quality) to high yield ('junk' or low quality). Moodys and Standard and Poors (S&P) are two well-known bond rating companies.

MOODYS	S&P	DESCRIPTION
Aaa	**Aaa**	**Highest quality, lowest degree of default**
Aa	**AA**	**High quality, low risk of default**
A	**A**	**Upper medium quality**
Baa	**BBB**	**Medium quality, lowest rating still considered 'investment grade'**
Ba	**BB**	**High yield**
B	**B**	**High yield**
C	**C**	**Highly speculative**
D	**D**	**In default**

Generally, the higher the rating, the lower the interest rate on the bond. Both rating companies now issue further distinguishers (i.e. A-) to further identify risks to specific issues.

Interest Rate
INFORMATION

NOMINAL YIELD (COUPON RATE) The rate stated that a bond pays.

CURRENT YIELD The annual interest payment divided by the market price of the bond.

YIELD TO MATURITY The rate that takes into account any gains or losses if held to maturity.

YIELD TO CALL Same as the yield to maturity except calculates the yield to call date.

Interest Rate Example

DESCRIPTION	NOMINAL YIELD	PRICE	CURRENT YIELD	YIELD TO MATURITY
ABC 7% 10/31/2020	7%	$101	6.93%	6.78%
DEF 12% 12/31/2050	12%	$100	12%	12%
XYZ 9% 06/30/2025	9%	$99	9.09%	9.20%

- A bond trading at premium* (ABC) will always have a higher nominal yield than yield to maturity.
- A bond trading at par* (DEF) will have all yields the same.
- A bond trading at a discount* (XYZ) will always have a higher yield to maturity than nominal yield.

*Trading at par means the bond is trading at its face value and will have a yield equal to its coupon. Trading at premium means the bond is trading above its par value and it offers a coupon rate that is higher than prevailing interest rates. Trading at discount conversely means the bond is trading below its par value and the coupon rate is below prevailing interest rates.

OUTSIDE FACTORS

While risks of the issuing company and ratings generally determine the relative price of bonds in the market, in the secondary market it is important to note that other economic factors affect the overall value of bonds, such as:

- The Federal Reserve changes the target level interest rate (Fed Funds rate)
- International changes in interest rates
- Advances / Declines in the Stock Market
- Higher overall defaults in an economy
- Advances / Declines in particular industries

Fun Facts

- The term ‘coupon rate’ originates from physical coupons that the investor surrenders to collect interest payments.
- Between 1980 and 2009, the Fed Funds rate has varied between 0% and 20%

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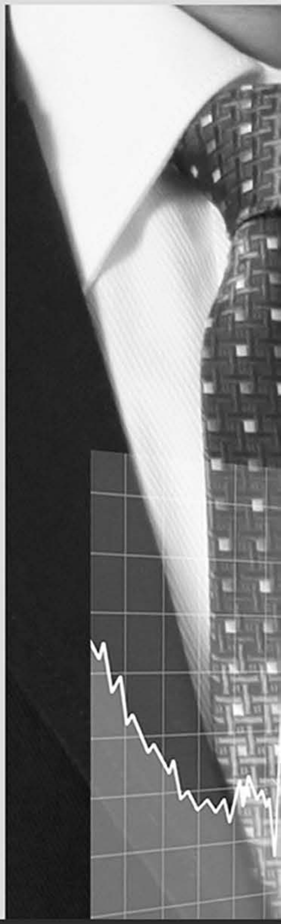

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