# Corporate Bond Investing for Total Return

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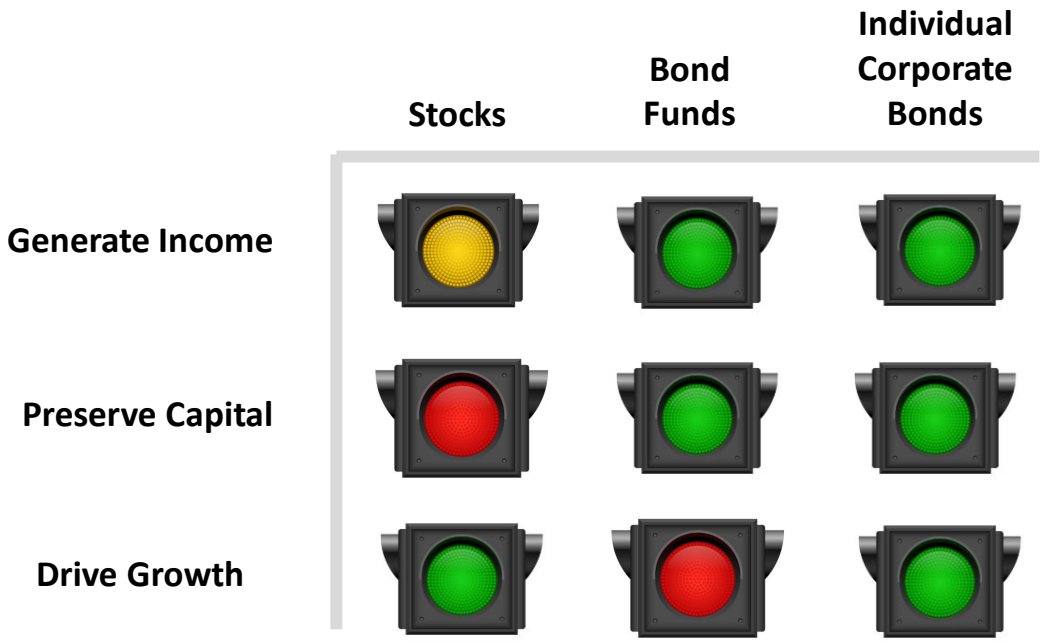
# Let's Stop Putting Bonds in a Box

**Many investors believe:**

1) Bonds are purely income investments
2) When rates rise, all bond prices go down
3) Bonds are good for 'ballast' but little else

**BUT….**

Individual corporate bonds can achieve three key investment objectives, whereas other investments often cannot

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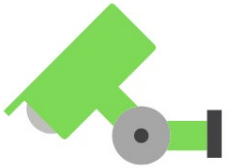
## Creating opportunities to increase bond total returns requires investors to:

1) **Be flexible:** Be willing to consider a variety of bonds across the credit and maturity spectrum

2) **Find value:** Identify bonds with compelling values relative to their price, yields, and issuer's financial strength



3) **Monitor:** Monitor bond price performance and issuing company's financial performance to determine whether to buy more, hold, or sell

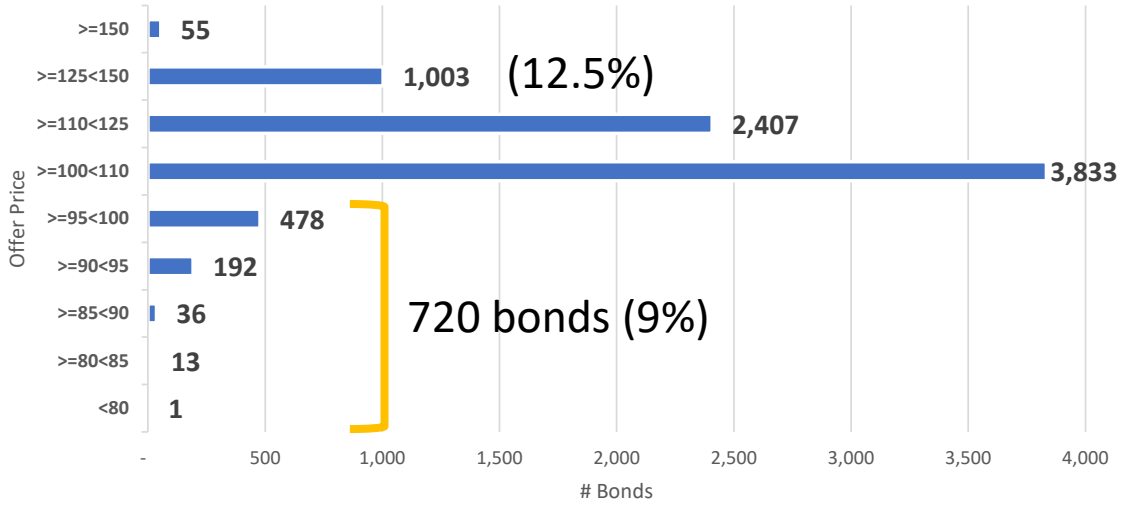
4) **Exit:** Sell bonds prior to maturity when their relative total return opportunity is no longer compelling

# Wide Pricing Disparity Can Create Opportunities

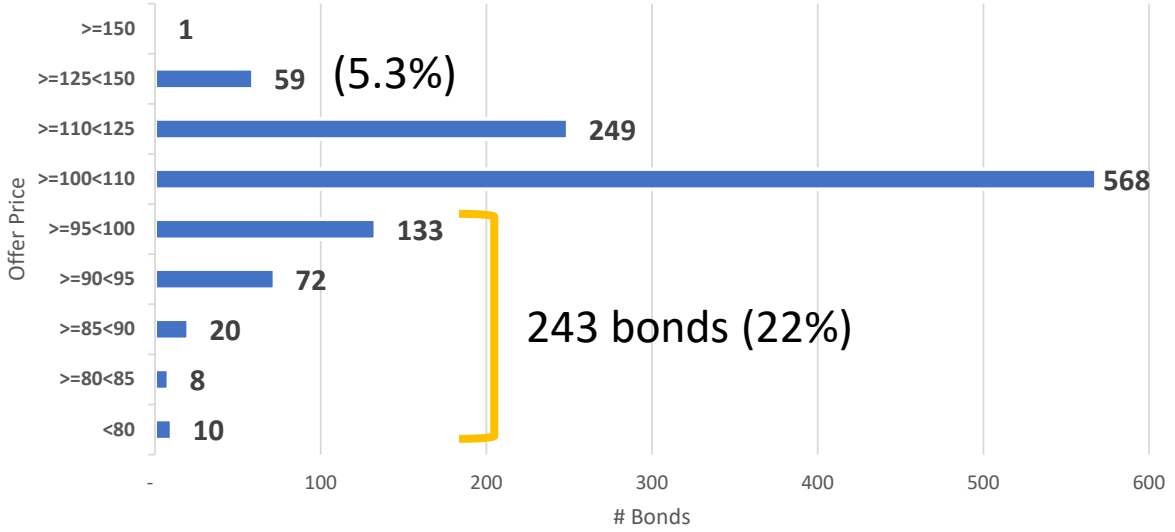
- In this recent bond search, the substantial majority of corporate bonds were trading between 80 to 150, which creates opportunities to maximize capital appreciation
- Investment-grade corporate bonds often have greater upside potential than high-yield corporate bonds given the latter's call provisions and shorter maturities

**Price Distribution from May 16, 2021 Corporate Bond Search on Fidelity.com**

**Investment Grade – 8,018 bonds**




**High Yield – 1,120 bonds**



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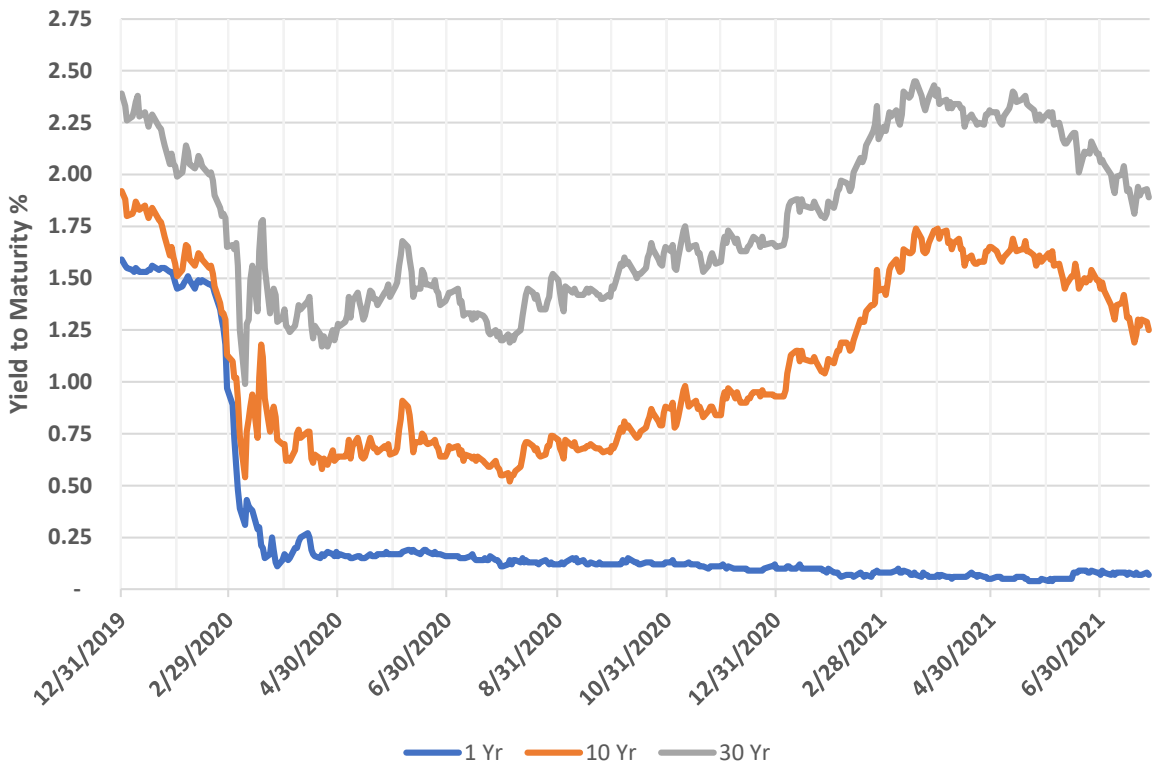
**Bond investors seeking to increase total returns should embrace and capitalize on pricing volatility**

# Bond Price Swings Can Create Compelling Opportunities

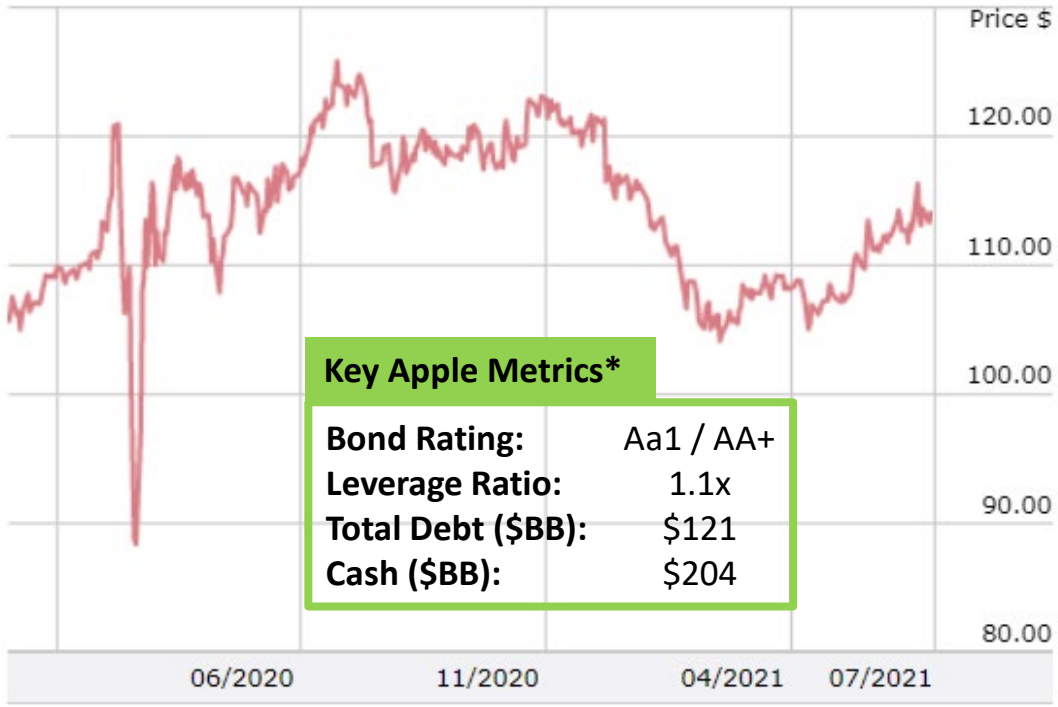
## Long-dated investment-grade bonds such as this Apple '45 bond can be volatile, including when it fell in the wake of COVID-19 and the Q4'20/Q1'21 spike in long-term Treasury yields

### US Treasury Yields




Source: US Treasury market data. Yields are from 12/31/19 through 7/27/21.

### Apple 3.45% 2/9/45 Historical Prices




**Key Apple Metrics***

| | |
|---|---|
| **Bond Rating:** | Aa1 / AA+ |
| **Leverage Ratio:** | 1.1x |
| **Total Debt ($BB):** | $121 |
| **Cash ($BB):** | $204 |

Source: FINRA market data. Prices from 12/31/19 through 7/27/21.

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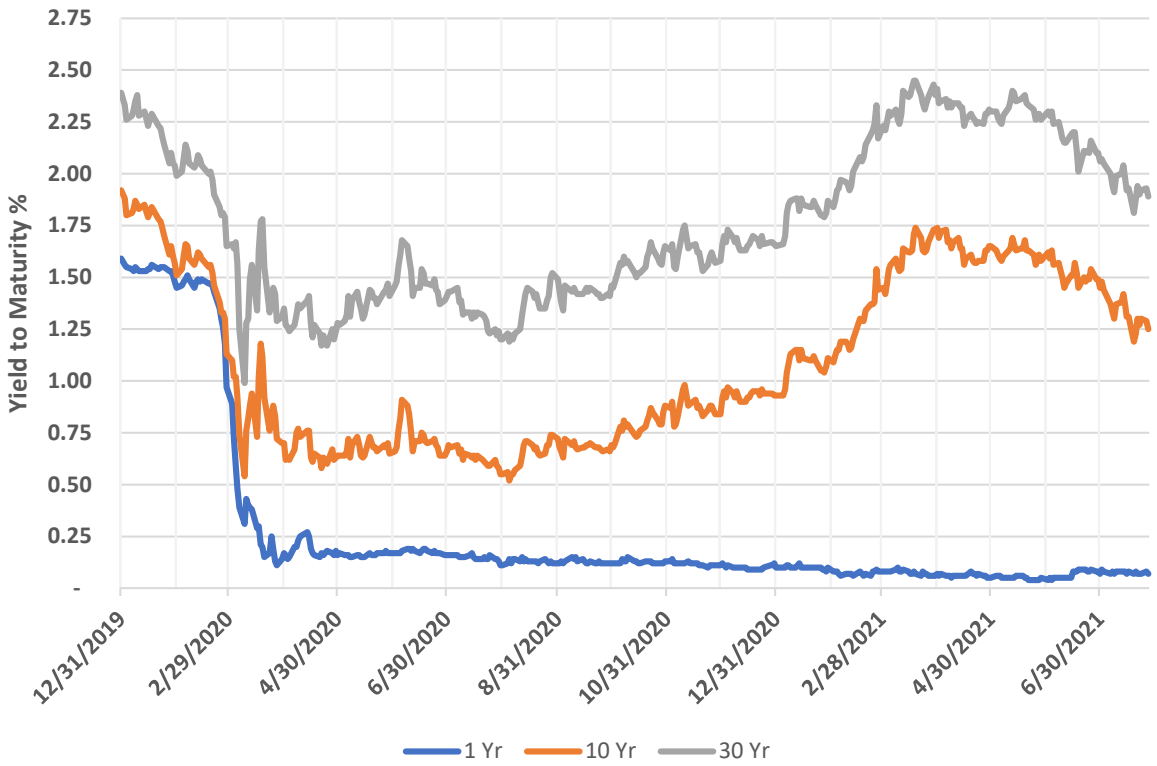
* Bond rating is as of July 14, 2021. Financial metrics are as of March 27, 2021 and are BondSavvy calculations based on information contained in Apple's SEC filings.

# Lower Price Volatility of Large Bond Index Funds

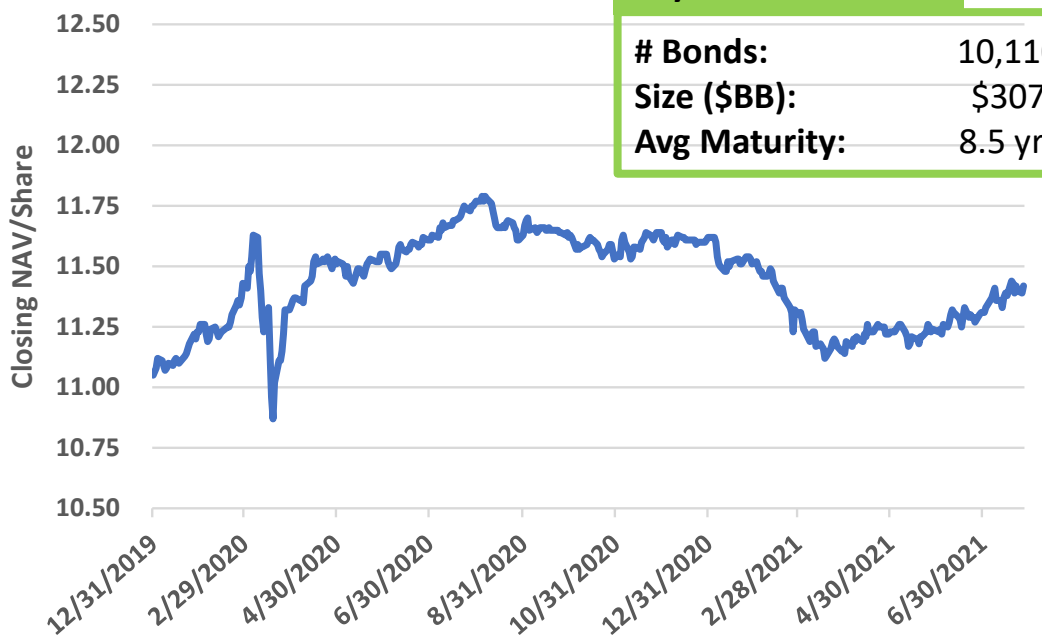
## Capital appreciation in large bond index funds is typically limited since their holdings of thousands of bonds can reduce pricing volatility

### US Treasury Yields




Source: US Treasury market data. Yields are from 12/31/19 through 7/27/21.

### Vanguard Total Bond Market Index Fund (VBTLX) Performance




**Key VBTLX Metrics***

| | |
|---|---|
| **# Bonds:** | 10,110 |
| **Size ($BB):** | $307 |
| **Avg Maturity:** | 8.5 yrs |

Source: Nasdaq market data. Prices from 12/31/19 through 7/27/21.

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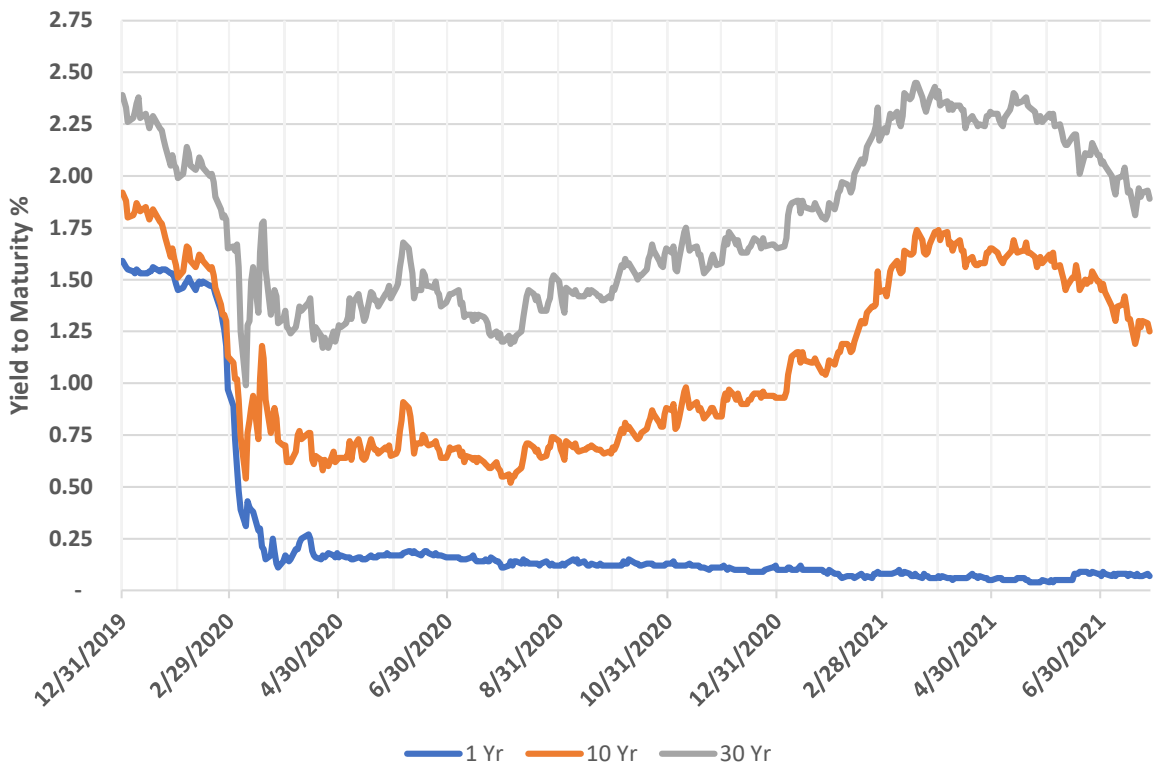
* Data are per the Vanguard.com website and are as of May 31, 2021.

# Many Bonds Are *Not* Sensitive to Changes in Treasury Yields

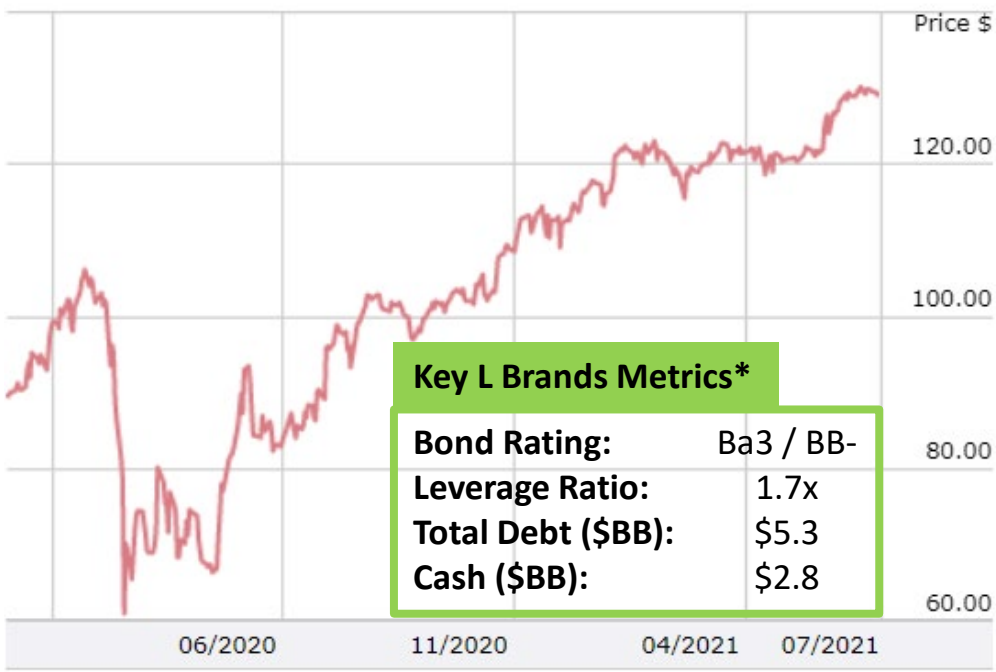
**High-yield corporate bonds, such as this L Brands '35 bond, are generally not sensitive to changes in Treasury yields, as the L Brands bond price increased when long-term Treasury yields surged**

**US Treasury Yields**




Source: US Treasury market data. Yields are from 12/31/19 through 7/27/21.

**L Brands 6.875% 11/1/2035 Historical Prices**




**Key L Brands Metrics***

| | |
|---|---|
| **Bond Rating:** | Ba3 / BB- |
| **Leverage Ratio:** | 1.7x |
| **Total Debt ($BB):** | $5.3 |
| **Cash ($BB):** | $2.8 |

Source: FINRA market data. Prices are from 12/31/19 through 7/27/21.

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* Bond rating is as of July 14, 2021. Financial metrics are as of May 1, 2021 and are BondSavvy calculations based on information contained in L Brands' SEC filings.

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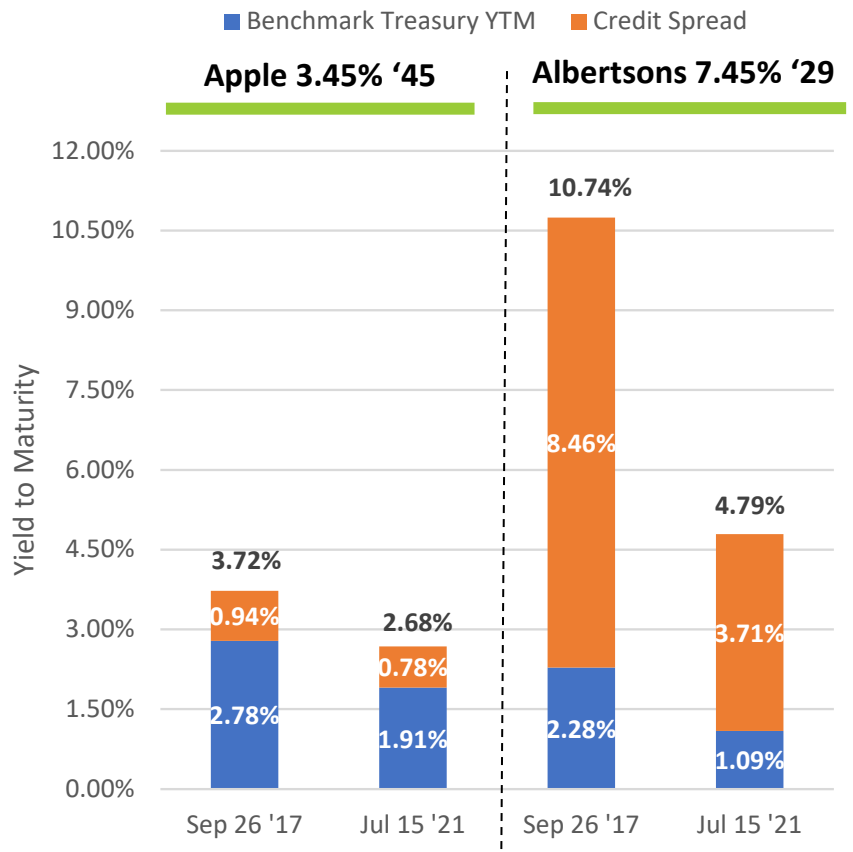
# What Makes Corporate Bond Prices Move?

**Building Blocks of Corporate Bond YTMs***




| | Apple 3.45% '45 | | Albertsons 7.45% '29 | |
|---|---|---|---|---|
| | Sep 26 '17 | Jul 15 '21 | Sep 26 '17 | Jul 15 '21 |
| Offer Price | 95.34 | 113.32 | 78.40 | 117.54 |
| Bond Rating | Aa1 / AA+ | Aa1 / AA+ | B3/B- | Ba3/B |

**Since BondSavvy recommended the Albertsons '29 bond in Sept '17, it has increased in value for reasons different than the price increase of the Apple '45 bond**

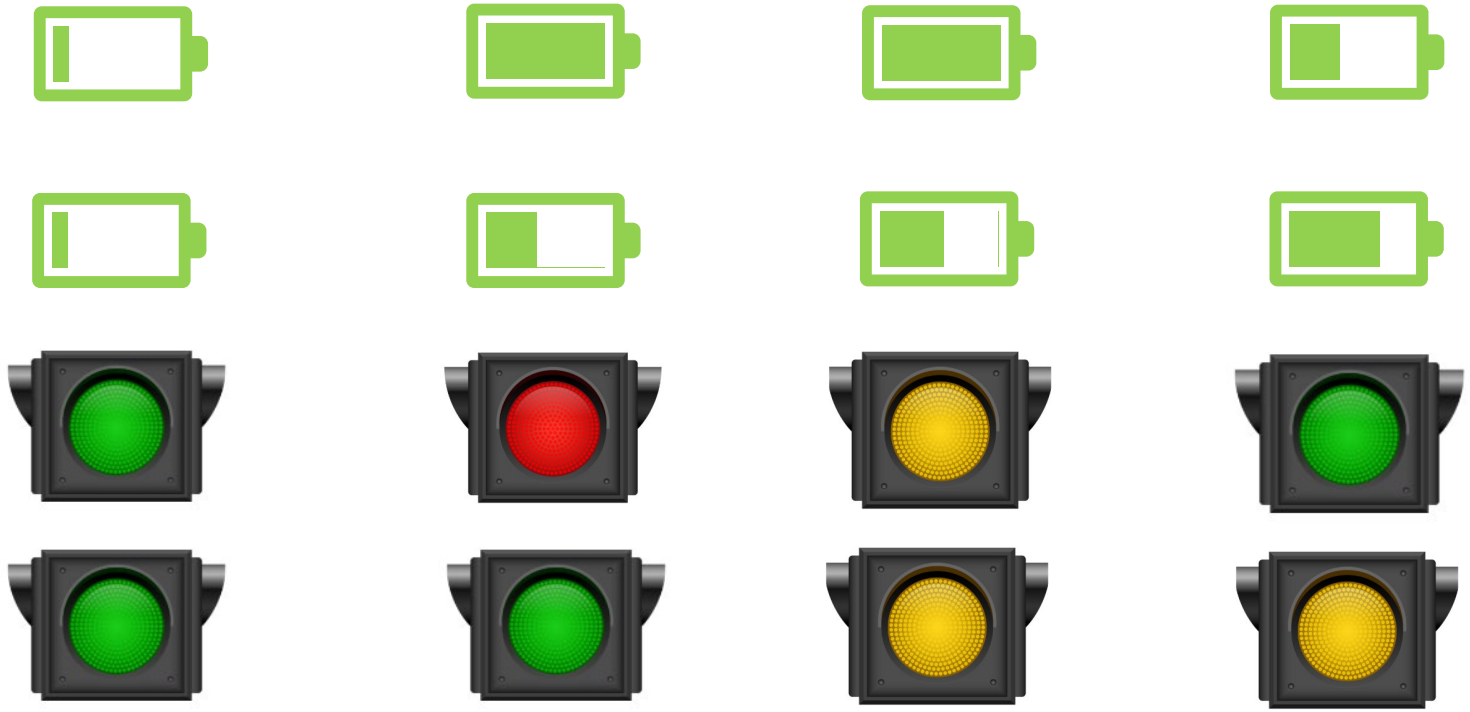
**Select Differences Between Investment Grade and HY Bonds****

| | Investment Grade | High Yield |
|---|---|---|
| Credit Spread as Proportion of YTM | Smaller | Larger |
| Maturity when Issued | 30+ Years | 5-10 Years |
| How Quoted on Institutional Desk | Credit Spread | Dollar Price |

* Pricing sourced from Fidelity.com and FINRA market data. ** Differences shown are general in nature and can vary from bond to bond.

# We look to own a variety of bonds in Groups 2-4 that can achieve strong total returns

| | GROUP 1 | GROUP 2 | GROUP 3 | GROUP 4 |
|---|---|---|---|---|
| | Short-Term Investment Grade Bonds | Long-Term Investment Grade Bonds | "Fallen Angels*" | High Yield Bonds with Near-Term Call Dates |
| Upside Potential | | | | |
| Yields | | | | |
| Interest Rate Risk | | | | |
| Credit Risk | | | | |



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* "Fallen Angels" are bonds that were previously rated investment grade (at least Baa3 / BBB- by Moody's and S&P) but were subsequently downgraded to below investment grade.

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# A Longer-Term Outlook Can Provide Comfort to Those Investing in Long-Term Investment Grade Bonds

**30-Year US Treasury Yields and Months & Change from Peak to Trough***

- Investors don't need to predict where the Treasury market will be at a precise period in the future
- Since 2007, peak-to-trough periods have ranged from 5 months to 28 months
- If Treasury yields spike immediately following an investment, all is not lost:
  - We can purchase more of the same bond at a better price
  - At some point, there should be another reduction in Treasury YTMs, which should bolster the value of long-term investment-grade corporate bonds

* Source of yield data points is US Treasury Department data. Data are from Jan 2, 2007 through July 15, 2021.

# HOW CALL PROVISIONS IMPACT INVESTMENT DECISIONS

# Bondholder-Friendly Make-Whole Call Provisions

Fidelity | CUSTOMER SERVICE | PROFILE | OPEN AN ACCOUNT | VIRTUAL ASSISTANT | LOG OUT | Search or ge

Accounts & Trade | Planning & Advice | News & Research | Investment Product

Research > Fixed Income > Individual Bonds > Search Results

APPLE INC NOTE CALL MAKE WHOLE
3.45000% 02/09/2045 ISIN #US037833BA77 SEDOL #BVVCSF2

Overview | Price & Performance

**Details**

| | |
|---|---|
| CUSIP | 037833BA7 |
| ISIN | US037833BA77 |
| SEDOL | BVVCSF2 |
| Pay Frequency | SEMI-ANNUALLY |
| Coupon | 3.450 |
| Maturity Date | 02/09/2045 |
| Moody's Rating | AA1 |
| S&P Rating | AA+ |
| Issuer Events | YES |
| FINRA | YES |
| Survivor Option | N/A |
| Bond Type | Corporate |
| Sector | ELECTRIC SERVICES |
| Interest Accrual Date | 02/09/2015 |

**Issuer Information**

| | |
|---|---|
| Issue Date | 02/02/2015 |
| Dated Date | 02/09/2015 |
| First Coupon Date | 08/09/2015 |
| Next Coupon | 08/09/2021 |
| Last Coupon | 08/09/2044 |
| Workout Date | 02/09/2045 |
| Original Issue Amount | $2,000,000,000.00 |
| Issue Price | -- |

**Coupon Information**

| | |
|---|---|
| Coupon Type | FIXED |
| Current Rate Effective Date | 02/03/2015 |
| Day Count Basis | 30/360 |
| Trading Flat | NO |
| Reset Frequency | TERM MODE |
| Benchmark Reference | -- |
| Benchmark Formula | -- |
| Next Reset Date | -- |
| Next Reset Rate | -- |
| Minimum Rate | -- |
| Maximum Rate | -- |

**Redemptive Features**

| | |
|---|---|
| Call Protection | View Schedule NO |
| Continuously Callable | YES |
| Called Bonds | NO |
| Make Whole Call | YES |
| Conditional Call | NO |

- Investment-grade corporate bonds such as the Apple '45 bonds typically have 'make-whole' call provisions
- While these bonds are technically "continuously callable," the issuer would have to pay the present value of all future interest and principal payments to effect the make-whole call

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**Call Schedule**

APPLE INC NOTE CALL MAKE WHOLE3.45000% 02/09/2045 ISIN #US037833BA77 SEDOL #BVVCSF2

| | |
|---|---|
| Call Defeased | NO |
| Continuously Callable | YES |
| Callable After | -- |
| Next Call Date * | -- |
| Extraordinary Redemption | NO |
| Make Whole Call | YES |
| Conditional Call | NO |

* The Next Call Date is, where applicable, the earlier of either the continuously callable effective date calculated from the current business day, or the next scheduled call date.

| Call Date | Call Price | Call Type |
|---|---|---|

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- Given their high cost, issuers seldom invoke make-whole calls
  - For these bonds, YTM and yield to worst (YTW) are equal, which removes upside constraint
- When Fidelity customers click "View Schedule" for make-whole bonds, they will see no specific call dates or prices

# Bondholder-*Un*friendly Call Schedules

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Accounts & Trade | Planning & Advice | News & Research | Investment Produc

Research > Fixed Income > Individual Bonds

**M/I HOMES INC NOTE**
5.62500% 08/01/2025

Overview | Price & Performance

**Details**

| | |
|---|---|
| CUSIP | 55305BAQ4 |
| ISIN | US55305BAQ41 |
| SEDOL | BF032M9 |
| Pay Frequency | SEMI-ANNUALLY |
| Coupon | 5.625 |
| Maturity Date | 08/01/2025 |
| Moody's Rating | BA3 |
| S&P Rating | BB- |
| Issuer Events | YES |
| FINRA | YES |
| Survivor Option | N/A |
| Bond Type | Corporate |
| Sector | OTHER INDUSTRIALS |
| Interest Accrual Date | 08/03/2017 |

**Issuer Information**

| | |
|---|---|
| Issue Date | 07/31/2017 |
| Dated Date | 08/03/2017 |
| First Coupon Date | 02/01/2018 |
| Next Coupon | 08/01/2021 |
| Last Coupon | 02/01/2025 |
| Workout Date | 07/17/2021 |
| Original Issue Amount | $250,000,000.00 |
| Issue Price | -- |

**Coupon Information**

| | |
|---|---|
| Coupon Type | FIXED |
| Current Rate Effective Date | 10/03/2017 |
| Day Count Basis | 30/360 |
| Trading Flat | NO |
| Reset Frequency | TERM MODE |
| Benchmark Reference | -- |
| Benchmark Formula | -- |
| Next Reset Date | -- |
| Next Reset Rate | -- |
| Minimum Rate | -- |
| Maximum Rate | -- |

**Redemptive Features**

| | |
|---|---|
| Call Protection | View Schedule NO |
| Continuously Callable | YES |
| Called Bonds | NO |
| Make Whole Call | NO |
| Conditional Call | YES |

- Most high-yield corporate bonds, on the other hand, are subject to specific call schedules
- These callable bonds do not have a make-whole call but rather can be called at specific prices and on specific dates

Fidelity.com | Print | Close

**Call Schedule**

M/I HOMES INC NOTE 5.62500% 08/01/2025

| | |
|---|---|
| Call Defeased | NO |
| Continuously Callable | YES |
| Callable After | 08/01/2020 |
| Next Call Date * | 07/18/2021 |
| Extraordinary Redemption | NO |
| Make Whole Call | NO |
| Conditional Call | YES |

* The Next Call Date is, where applicable, the earlier of either the continuously callable effective date calculated from the current business day, or the next scheduled call date.

| Call Date | Call Price | Call Type |
|---|---|---|
| 08/01/2020 | 104.219 | Premium |
| 08/01/2021 | 102.813 | Premium |
| 08/01/2022 | 101.406 | Premium |
| 08/01/2023 | 100.000 | Par Call |

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- Upon clicking "View Schedule," investors will see when and at what prices the bond may be called
- If the bond's price goes above the next call price, the bond's YTW will fall below the YTM, which caps the upside on callable bonds

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# How To Incorporate Call Provisions Into Investment Decisions

## 1) Purchase price vs. next call price

- Onerous call provisions can filter out investments that are otherwise compelling

## 2) Yield gain vs. call price ceiling

- If a callable high-yield bond offers a slightly higher YTM than an investment-grade bond, this can often not be worth it if the first call price is only slightly above the current price

## 3) Appreciated price vs. next call price

- After making an investment, we closely monitor the issuer's financial performance and the bond price relative to the call price when updating buy/sell/hold decisions

# CASE STUDIES OF TWO RECENT BUY/SELL RECOMMENDATIONS

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# CASE STUDY
# M/I Homes 5.625% 8/1/25

## BUY RATIONALE

- Relatively high yield for a bond issuer that had consistently solid operating performance and a strong balance sheet
- Capital allocation focused on growing the business rather than share buybacks and dividends

## SELL RATIONALE

- While M/I Homes' financial performance had been strong, the next call price was 102.813 on August 1, 2021
- This placed a ceiling on the bond, and better opportunities were available
- There was also the risk of a partial call, which would have been penal in this less-liquid bond

**Key M/I Homes Metrics: Buy vs. Sell Date**

| | Buy Date | Sell Date |
|---|---|---|
| Date | 3/15/19 | 1/11/21 |
| Price* | 95.98 | 103.15 |
| YTM | 6.42% | 4.84% |
| Leverage Ratio** | 3.2x | 2.0x |

**TOTAL RETURN***

| M/I Homes '25 | iShares HYG |
|---|---|
| 18.20% | 11.66% |

* Price and total return calculations based on top-of-book offer price available on Fidelity.com at 1:00pm on 3/14/19 (plus a 0.1-point markup) and Steve Shaw's Fidelity.com execution price at 1:32pm ET on 1/11/21.

** Calculated based on the most recent financials available on the recommendation and sell dates.

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# CASE STUDY
# Verizon 3.85% 11/1/42

## BUY RATIONALE

- High credit spread relative to the bond issuer's default risk and leverage
- We are big believers in buying long-term investment grade bonds at a discount
- Diversified our 9/26/17 picks to include a blue-chip wireless operator

## SELL RATIONALE

- Revenues were flat and, given Verizon's high capex and big dividend, we didn't see a catalyst for an improved credit profile
- Also, we didn't believe the credit spread could materially fall, as the Apple 3.85% '43 credit spread was 1.09% vs. 1.36% for Verizon '42

**Key Verizon Metrics: Buy vs. Sell Date**

| | Buy Date | Sell Date |
|---|---|---|
| Date | 9/26/17 | 9/9/19 |
| Price* | 89.72 | 106.43 |
| YTM | 4.55% | 3.44% |
| Credit Spread | 1.82% | 1.36% |
| Leverage Ratio** | 2.5x | 2.4x |

| TOTAL RETURN* | |
|---|---|
| Verizon '42 | iShares LQD |
| 27.01% | 12.53% |

* Price and total return calculations based on top-of-book offer price available on Fidelity.com at ~3:00pm on 9/25/17 (plus 0.1-point markup) and Steve Shaw's Fidelity.com execution price at 3:57pm ET on 9/9/19.

** Calculated based on the most recent financials available on the recommendation and sell dates.

# Other Factors We Consider When Recommending Bonds

- Revenue and earnings growth outlook
- Upcoming bond maturities
- Existence of financial covenants and covenant ‘elbow room’
- Capital allocation
- Likelihood of bond rating upgrade or downgrade
- Industry concentration and trajectory
- Interest rate risk
- Seniority in capital structure
- Call schedule, if applicable

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# Thank you

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# APPENDIX

# Doesn't inflation erode the value of bonds?

- Believing "if inflation goes up, bond prices go down" oversimplifies how the bond market works
- Inflation is one of many factors that impacts US Treasury yields, as shown in the chart
- If rampant inflation ensues, it could hurt long-term investment grade bonds

**BUT…**

- Higher commodity prices have driven high yield bonds issued by oil & gas and other commodity-based issuers higher

**Key Recent Drivers of Long-Term US Treasury Bond Yields**

**Factors driving Treasury yields higher**

- Record levels of US Treasury issuance
- *Higher inflation expectations*
- Increased appetite for riskier investments as economy recovers
- Reduced Treasury purchases by foreign investors

**Factors driving Treasury yields lower**

- Treasury yields still high vs. Germany and Japan
- Fed purchases of Treasurys
- Global growth outlook still mixed
- Q4 '20 and Q1 '21 taxable bond fund inflows at highest levels since 2008
- *Technology and globalization have kept inflation low for decades*

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