

# Rethinking Bond Investing

Steve Shaw  
Founder & President, BondSavvy

[steve@bondsavvy.com](mailto:steve@bondsavvy.com)

August 6, 2019

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# Let's Challenge Long-Held Bond-Investing Beliefs

- Investors can't beat the index
- Always hold bonds to maturity
- Build a laddered bond portfolio
- Focus on a bond's yield not the price at which you buy
- Bonds only return 2-4%
- If 'interest rates' rise, bond prices ALWAYS fall
- A credit rating and a yield is all you need to evaluate a bond

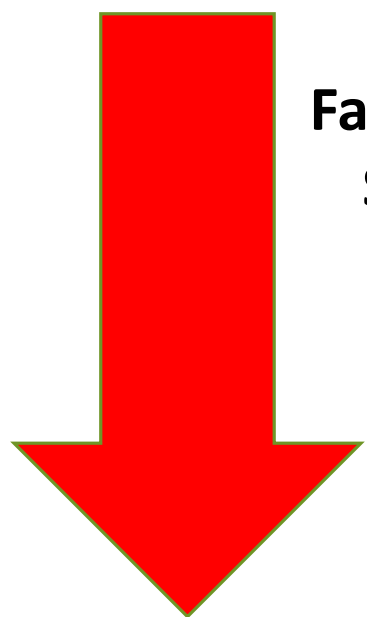
# Attributes of Individual Corporate Bonds

- Contractual interest payments and return of principal
- Financial covenants that protect investors
- Senior to common and preferred stock
- Wide variety of risk/reward opportunities
- Many areas of corporate bond market performed well when stocks collapsed in Q4 2018

# Individual corporate bonds can help to balance stock market volatility

## JANUARY 3, 2019 PRICE PERFORMANCE

### Apple Stock



Falls 10% from  
\$158.34 to  
\$142.09



### Apple 3.45% '45 Bonds



Unchanged at 88.50\*



# Important To Focus on Yield AND Capital Appreciation

‘Buy low and sell high’ can apply to bonds and generate returns higher than a bond’s YTM

Risk							
Credit	Interest Rate	Bond	Bond Price: Investment Date vs. Sell Date		Investment Date YTM	Annualized Return Through Sale	
Low	Highest	Apple 3.850% '43	85.07	95.32	4.8%	6.4%	
			10/28/13	5/9/18			
Higher	Low	Cablevision 5.875% '22	79.25	99.12	10.1%	17.6%	
			12/8/15	1/9/18			
Highest	None	Toys R Us 10.375% '17	83.08	102.59	24.6%	54.2%	
			2/12/16	9/29/16			

**Please note:** Selling bonds prior to maturity will not always result in returns in excess of the bond’s Yield To Maturity. Selling prior to maturity may result in lower returns than if the bond was held through to maturity.

## Question 1:

***How can investors find value in the US corporate bond market?***

## Question 2:

***Why buy bonds if 'interest rates' can only go up?***



# ‘Interest Rates’ – An Often Misused and Overused Term

‘Interest rates’ set by the Fed often have limited impact on corporate bond prices

Term	Interest Rates	Treasury Yields	Corporate Bond Returns
Example	Fed funds rate	10-Year Treasury yield	Verizon 3.85% 11/1/42 Albertsons 7.45% 8/1/29
Determined by	Federal Reserve	Market supply & demand	Inv Grade: Credit spreads + Treasury yields High Yield: Credit quality changes
Impacts	Prime rate, car loans, credit card rates, mortgages	Investment-grade corporate bonds, bank loans, mortgages	Investment profit

# Credit Spreads – Step 1 To Understanding Bond ‘Value’

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VERIZON COMMUNICATIONS INC

3.85000% 11/01/2042NOTE CALL MAKE WHOLE

Overview

Price & Performance

Basic Analytics

Price (Bid)	94.729
Price (Ask)	95.378
Depth of Book	View
Ask Yield to Worst	4.161%
Ask Yield to Maturity	4.161%
Current Yield	4.036%
Yield to Sink	--
Third Party Price	94.539
Spread to Treasuries	1.445
Treasury Benchmark	23 YR.(2.750% 11/15/2042)
Recent Trade	View Recent Trades
Price	94.796
Quantity	800
Date/Time	05/22/2019 16:30:55
Buy/Sell	CS

Complex Analytics

Duration to Worst	15.071
Option Adjusted Duration	15.080
Option Adjusted Spread	416.056
Convexity to Worst	300.969
Option Adjusted Convexity	300.969

$$\begin{array}{rcl}
 \text{Benchmark Treasury YTM} & & 2.716\% \\
 & + & \\
 \text{Credit Spread} & & 1.445\% \\
 & = & \\
 \text{Verizon 3.85\% '42 YTM} & & 4.161\%
 \end{array}$$

# Deciding When To Sell a Bond

## Marriott Int'l 3.125% 6/15/26 Bond

### December 12, 2018 Investment Date

**Benchmark  
Treasury YTM** **2.80%**

+

**Credit Spread** **1.78%**

=

**Corporate Bond  
YTM** **4.58%**

**Ask Price:** **90.83**

### May 15, 2019 Update

**Benchmark  
Treasury YTM** **2.31%**

+

**Credit Spread** **1.09%**

=

**Corporate Bond  
YTM** **3.40%**

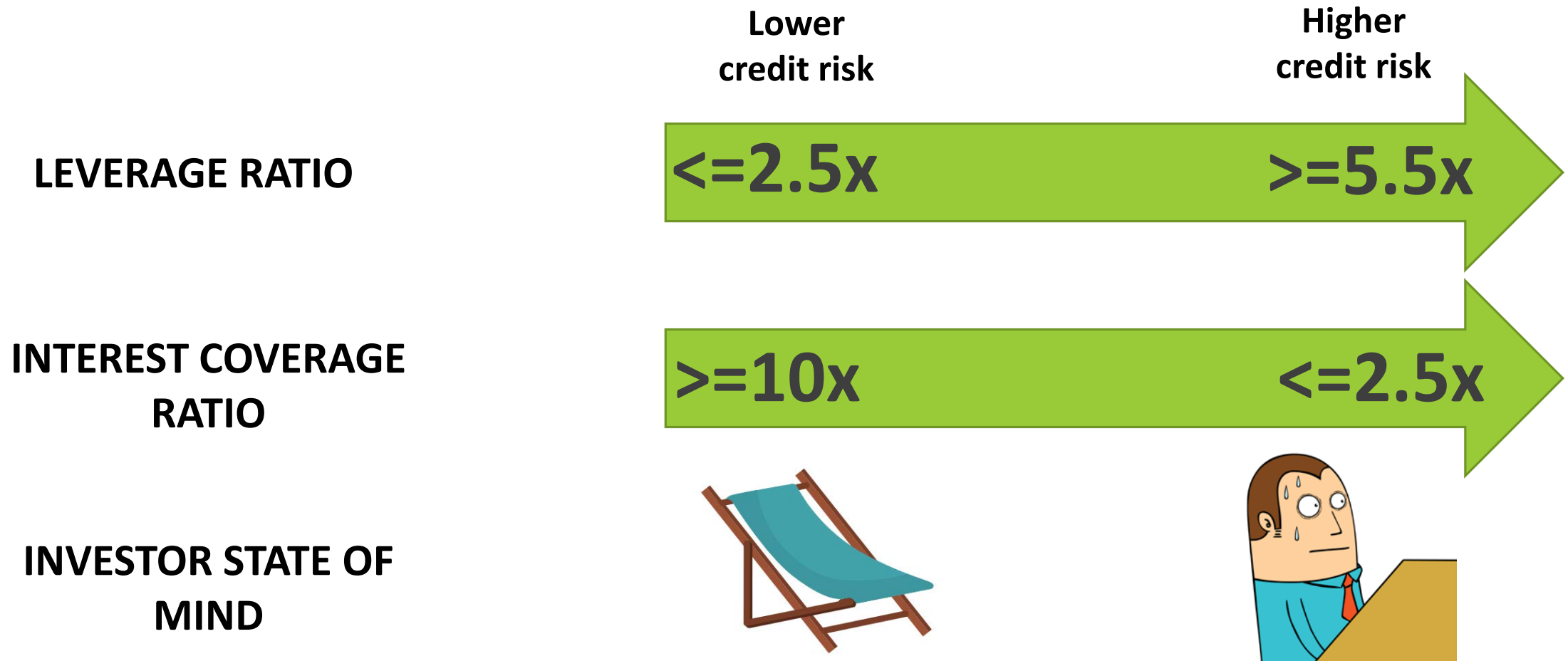
**Ask Price:** **98.29**

- Since December 12, Treasuries rallied AND the bond's credit spread fell to a level below that of comparable bonds
- No credit rating change during the five-month period
- We saw little upside remaining in the bond on May 15

# Overlaying Financial Metrics with Credit Spreads

EBITDA	INTEREST COVERAGE RATIO	LEVERAGE RATIO
Earnings before interest, taxes, depreciation & amortization	$\frac{\text{EBITDA}}{\text{Interest Expense}}$	$\frac{\text{Long-Term Debt}}{\text{EBITDA}}$
	<i>Higher = lower default risk</i>	<i>Lower = lower default risk</i>
		<b>"Purer" of the two ratios</b>

# Corporate Bond 'Sweat Meter'



# Credit Ratings Can Be Helpful But Have Shortcomings

Moody's	S&P	
Aaa	AAA	Investment Grade
Aa1	AA+	
Aa2	AA	
Aa3	AA-	
A1	A+	
A2	A	
A3	A-	
Baa1	BBB+	
Baa2	BBB	
Baa3	BBB-	
Ba1	BB+	Non-Investment Grade or "High Yield"
Ba2	BB	
Ba3	BB-	
B1	B+	
B2	B	
B3	B-	
Caa1	CCC+	
Caa2	CCC	
Caa3	CCC-	

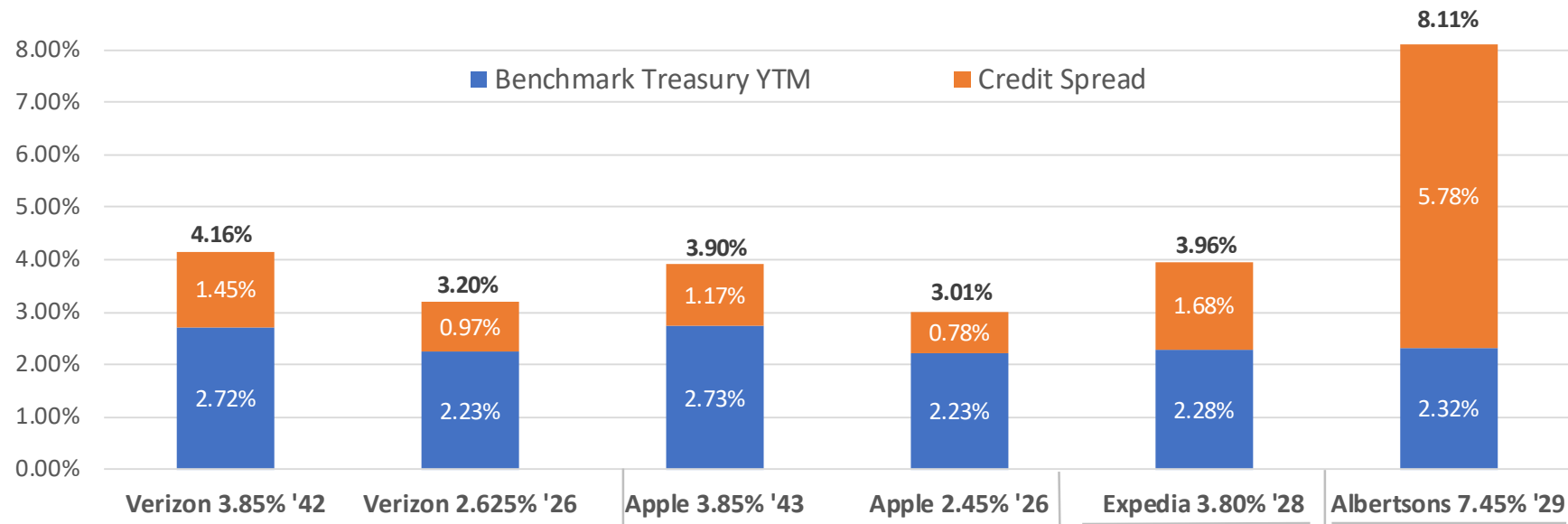
## Bond rating shortcomings

- Can often go years without changing
- Don't speak to the value of a bond
- Smaller companies with better financials often have lower ratings than bigger companies with worse financials

## **BUT...Understanding ratings is still important:**

- Rating impacts bond's Treasury-yield sensitivity
- Upgrades and downgrades can impact corporate bond prices

# Finding Value by Comparing Credit Spreads\* and Financials

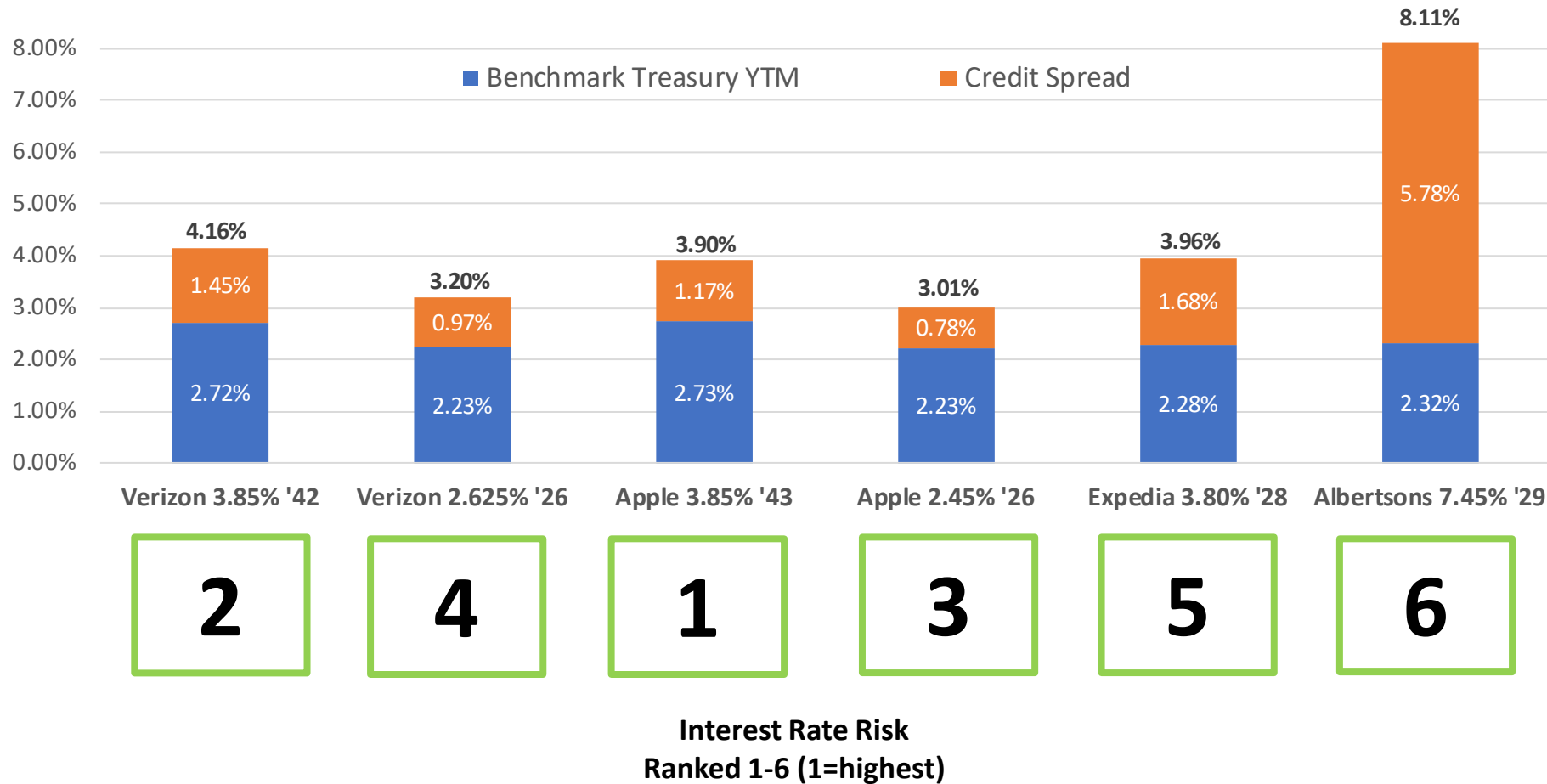


<b>Leverage Ratio (1)</b>	<b>2.4x</b>	<b>1.4x</b>	<b>1.8x</b>	<b>3.6x</b>
<b>Cash (1)</b>	<b>\$2.3</b>	<b>\$225.4</b>	<b>\$4.6</b>	<b>\$0.9</b>
<b>Debt (1)</b>	<b>\$113.7</b>	<b>\$112.6</b>	<b>\$3.7</b>	<b>\$9.8</b>
<b>Rating</b>	<b>Baa1 / BBB+</b>	<b>Aa1 / AA+</b>	<b><u>Ba1</u> / BBB</b>	<b>WD** / <u>CCC+</u></b>

**Understanding 'credit value' is key; however, investors must also understand how different bonds can react to changes in Treasury yields**



# How Credit Quality Impacts Interest Rate Risk



**Corporate bonds of higher credit quality tend to have greater interest rate risk due to their:**

- Longer initial maturities
- Lower coupons
- Institutional trading being indexed to the benchmark US Treasury

# Corporate Bonds Don't Move in Lockstep with Treasuries

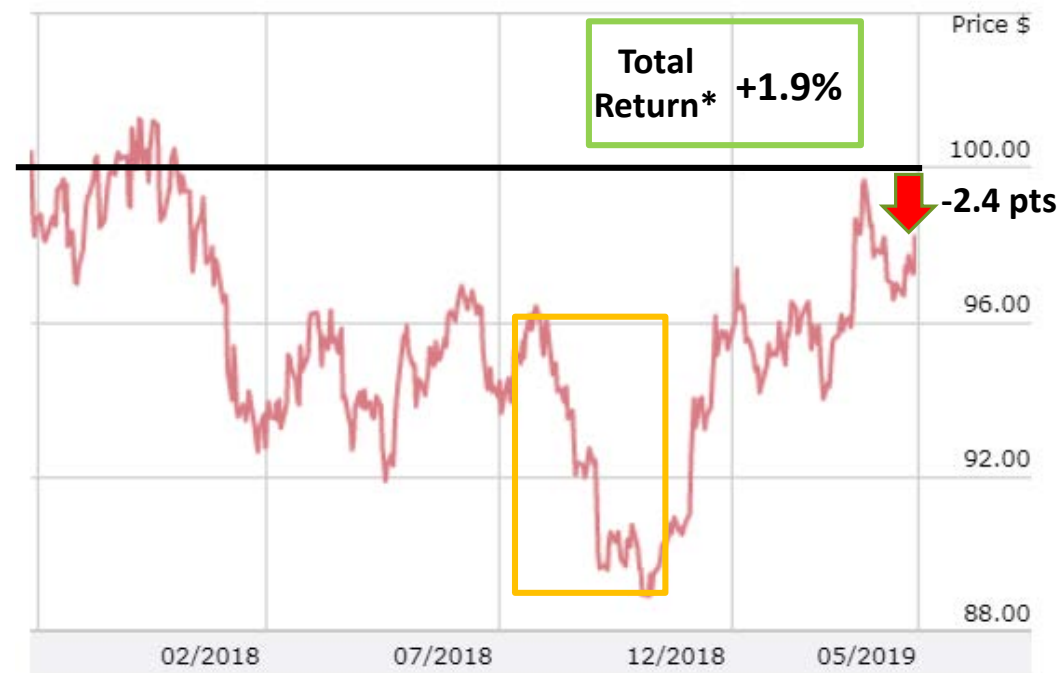
Investment-grade and high-yield corporate bonds react differently to changes in Treasury yields

**Verizon 3.85% 11/1/42 vs. Benchmark Treasury – Sep 25, 2017-Apr 30, 2019**

## Verizon 3.85% 11/1/42



## US Treasury 2.75% 11/15/42



# Not All Bonds Go Down When Treasury Yields Increase

Even as the comparable Treasury fell 7 points, this Albertsons '29 bond returned 33.6%\* due to strong performance and reduced concern around the Amazon / Whole Foods merger

Albertsons 7.45% 8/1/29 vs. Benchmark Treasury Price Performance – Sep 25, 2017-Apr 30, 2019

## Albertsons 7.45% 8/1/29



## US Treasury 6.125% 8/15/29



**Albertsons  
Leverage  
Ratio:**

**6/17/17: 4.3x**

**2/23/19: 3.6x**

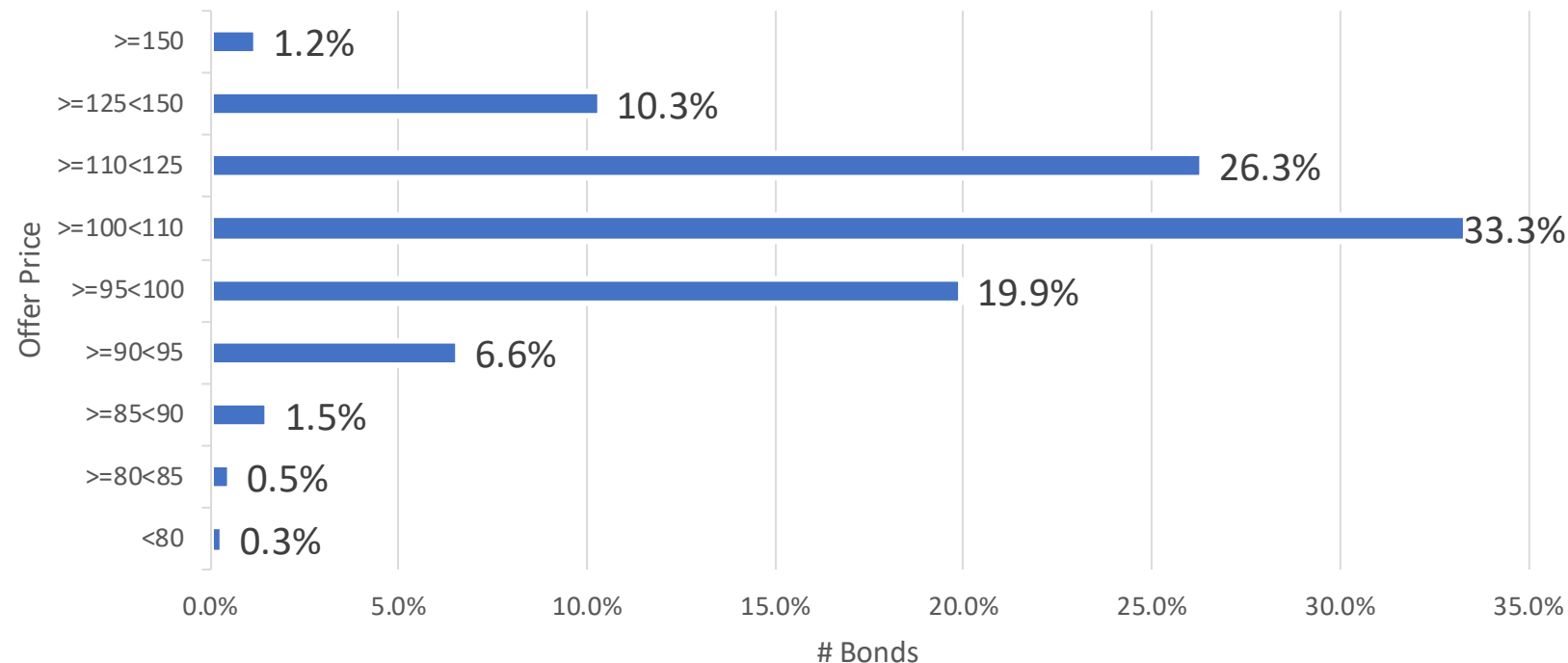
\* Albertsons return based on 9/25/17 offer price from Fidelity.com and 4/30/19 price from Fidelity brokerage statement. Treasury CUSIP: 912810FJ2. All other historical prices are from FINRA market data. Total returns include interest income and capital gains or losses.

# ***How To Invest Actively in Corporate Bonds***

# 'Buy Low and Sell High' Applies to Stocks AND Bonds

Bond investors should be mindful of an effective ceiling on bond prices

## Investment-Grade Bond Offer Prices – 1,587 Bonds – June 13, 2019

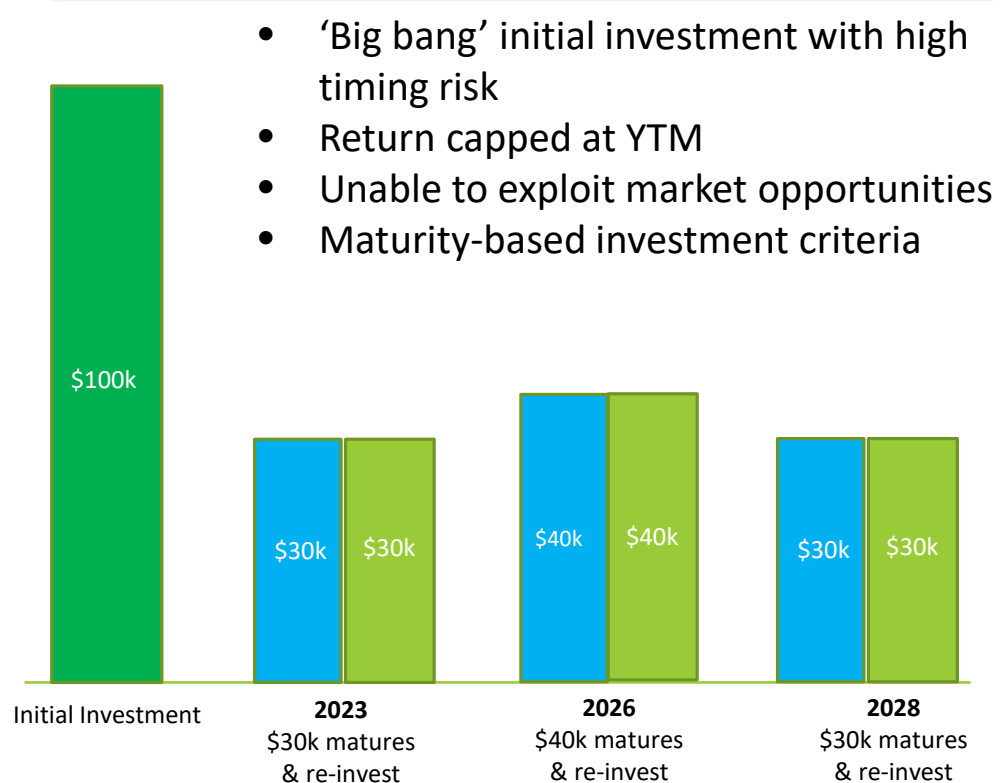


- Bonds trading at a discount generally have greater upside and less downside than premium bonds
- In a taxable account, \$1 of capital gain is worth more than \$1 of interest income
- Bond prices have ceilings, which often requires selling prior to maturity to maximize returns

# Active Corporate Bond Investing vs. Bond Laddering

Active bond investing has a number of advantages vs. traditional bond ladders

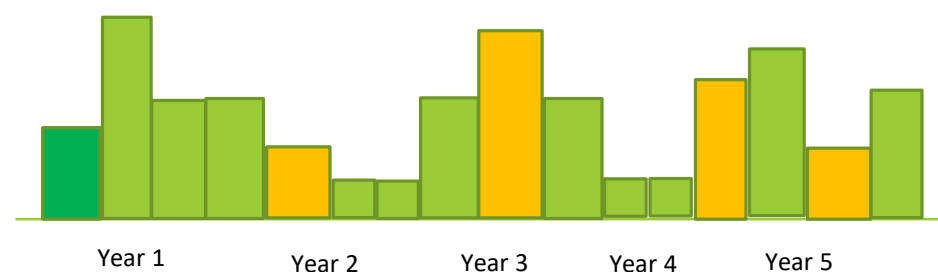
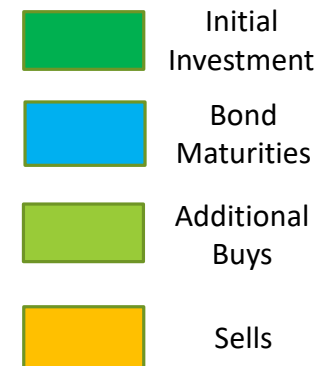
## Illustrative \$100k Bond Ladder



## Illustrative Active Corporate Bond Investing




- Reduce timing risk by investing over time
- Potentially increase returns by selling pre-maturity to enhance capital appreciation
- Modify approach as environment changes
- Bond selection based on value and not just a maturity date

### Legend:



# What Active Corporate Bond Investing Is and Is Not

## Active Corporate Bond Investing IS NOT

- 
- 
- 
- Day trading
  - Selling as soon as a bond goes up 10 points
  - Selling as soon as a bond goes down 10 points

## Active Corporate Bond Investing IS

- Generally 1- to 4-year holding period
- Maximize returns over 1- to 4-year periods
- Add to positions over time, including when prices fall

## Key Takeaways

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- Individual corporate bonds are not a monolithic asset class
- Investors can evaluate a bond's relative value by considering:
  - Credit spreads and financial ratios of comparable bonds and issuers
  - Dollar price relative to par value and opportunity for price appreciation
  - Sensitivity to Treasury yields based on credit rating and time until maturity
- Bond investment opportunities present themselves over time and bond prices have ceilings
  - These factors support an active approach to bond investing vs. bond laddering

***People who invest regularly in individual corporate bonds gain a strong understanding of the market, which can help improve performance over time***





Thank you

Steve Shaw  
[steve@bondsavvy.com](mailto:steve@bondsavvy.com)

(201) 748-9862

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