TRANSCRIPT

Corporate bond investing in unprecedented times

Richard Carter: Hello everyone, welcome to our webinar today on bond investing: "Corporate Bond Investing in Unprecedented Times." Today, I'm delighted to welcome Steve Shaw back to our Fixed Income Webinar series. Steve is founder and president of BondSavvy which is a research service specializing in helping individual retail investors to invest in individual corporate bonds. Steve is a 23-year veteran of the financial markets, working in corporate mergers and acquisitions, as well as heading up bond market venue Tradeweb Direct, for a time, which was one of the firms that Fidelity partners with to source our bond inventory. Steve founded BondSavvy in 2017.

So, Steve, it's great to have you back, and I think this is now becoming something of a regular event for us to hear from you over the summer. I know you've prepared a very interesting and topical set of slides for our audience today to enjoy as we go through the discussion. But before we dive in, I wonder if you could just start with a few words about how you see the bond market today, and particularly the corporate bond market, what's changed in this past year? I'm thinking of course, the events of March and subsequently.

Steve Shaw: Sure. Thanks, great to be with everybody. Thanks for joining. So, I'd say a couple things. First, you effectively have, in corporate bond land, that you have the have and the have nots; the haves and the have nots. Now you've had many companies that have been bolstered by COVID-19, so you've had grocery operators such as Kroger and Albertsons. You then have technology companies that have done very well. But then you had other companies, take a Southwest Airlines, or a Macy's that had really strong balance sheets going into COVID-19, but then as a result of COVID-19, yes, the Fed did some work so that they were able to access the capital markets. But now these companies have a lot of debt, and the revenue and earnings have gone down. So, you've got a lot of companies that, the game's been changed, and the question is, is how quickly are they going to be able to turn the corner and hopefully pay down some of that debt that they just borrowed?

The other thing is, is that if you look over the last, say, five to ten years, I would say the pendulum had really swung to the favor of stock investor, because you had all sorts of stock buybacks and dividend increases and all that kind of stuff, and I'd say the only thing that's happened is that I believe the pendulum has swung a little bit more back toward the bondholders over the last several months. Now you've had companies cut their dividends; they've reduced buybacks. And that all bodes well for bondholders. So those are a couple of things that I would go into.

Richard Carter: All right, well thank you Steve, that's a nice summary. And you know, there's a very good reason why you titled this webinar, "Unprecedented Times." We're sitting here this afternoon, I'm just noticing the 10-year treasury yield at 52 basis points, which reflects both the current recession, or at least the spare capacity in the economy, and the influence, perhaps, of the Fed actions as you alluded to as well. But maybe I could just begin then, kick it off today with asking you to help us, many of our clients talk about the scarcity of yields today, and many people might be considering dividend-paying stocks as one alternative. I believe the S&P dividend yield is running at about 1.9, nearly 2%. How would you look at the tradeoff, say, you know, in the search for income and for yield there versus taking it on a corporate bond universe?

Steve Shaw: Sure. And I'd say that many investors have, they look for income and they look for capital appreciation; I'd say that many investors historically have generally favored dividend stocks. But if you look at these 15 companies, they all have one thing in common. So first, they're all big companies, right? But they've all either suspended or reduced their dividends over the last several months. And again, these are some of the largest companies in the world.

You've got Boeing, Ford, Disney, Marriott, Royal Dutch Shell, one of the largest companies in the world. And so, few companies have been immune from what's been going on. And so, as you think about weighing income, it could behoove many investors to start thinking a little bit more carefully about individual corporate bonds.

And so, you have the CFO taking the money away from the dividend stock investors, and just to put a finer point on that, Richard, when you look at some of these companies, you've got, again, some of the biggest companies in the world, and you've got Royal Dutch Shell, and this is for last year, $345 billion of revenue, and it paid out $15 billion in dividends; it bought back $10 billion of stock. All these companies were in a similar boat. But then if you look at what happened, and I alluded to this earlier on, as these companies have had difficult times, they've suspended dividends. So Boeing and Disney suspended their dividends; Royal Dutch Shell cut its dividend by two-thirds, Anheuser-Bush Inbev by half, and three of the four have paused their buybacks, and you know, it's one thing Richard, if you make an investment in say, a high-yield bond that's rated B, and perhaps it's yielding 12%, and maybe that company has a tough time; perhaps it goes into default. But these are some of the most highly rated companies out there, and they stopped paying their dividends. So, I think it's really important for an investor to be mindful when things like this happen.

Richard Carter: Yeah, I think we heard today, didn't we, that BP has also cut its dividends, so it's certainly running across industries and some of the biggest companies. What is this, and this is very interesting to absorb here. Here we are in earnings season, we'd probably like to hear a few more. Translate that, if you could a bit more, Steve, for the bond investor; what does that look like from an experience point of view when you hear this type of news?

Steve Shaw: Sure. Well the thing to keep in mind is that, all those 15 companies, yes, they did suspend their dividends, but they've continued paying interest on their bonds. And so, you obviously have a key differential here in that stock dividends are not contractual; they can be taken away at any time compared to a coupon in a corporate bond that's contractual, and you're going to continue to receive that.

Now many investors, rightly, have been concerned about some of what they've been hearing, in terms of default rates, and the like, and how those have gone up. But, it's not as huge of an issue as many would be, as many would believe, just given where those default rates apply in terms of specific parts of the market. So, it's just as important for folks to understand that, if you're looking for income, that yes, you can continue to get that with dividend stocks; there's just a higher risk of that income compared to with a corporate bond.

Richard Carter: Okay, fair enough. Let's if we could just for a second dive into the world of defaults for a bit, because you know, certainly earlier in the year, if you remember, we heard a lot about the oil and gas sector being at risk, and more recently, of course, we've seen bricks-and-mortar retail suffer a lot from COVID and the lockdown aftereffects and so forth. How would we measure the seriousness, though, I feel like still we've not quite hit the rate in a macro sense, in a larger scheme of things, to the point of where it's sort of hitting the headlines every day. It's almost like there's a steady trickle, one-by-one, a few companies being hit by default. But maybe we could just sort of, as you I think here are about to do, provide some more data and some framing for people on default rates.

Steve Shaw: Sure, sure. So, it's important to split between high yield and investment grade. So for those who might be new to bond investing, corporate bond investing, so all bonds are rated by Moody's and S&P, and we'll talk about it a little bit further in the presentation, but if a bond is rated Baa3, BBB- or higher, that's deemed to be investment grade; those bonds are deemed to have a lower risk of default. And when you look at the default rate for those bonds, so here in the dark blue, that's investment grade, you'll see that it's very low. So, it's historically right around 0.05%. You'll see when you do have a little bit of a hiccup there, here was the financial crisis; that's when you had the Lehman bankruptcy. Back in 2001, that's when you had the Enron bankruptcy. So oftentimes when you have investment grade defaults, there's some sort of financial chicanery that's going on unfortunately.

Where most defaults are is in high yield. And you'll see that over the last several periods that you had higher defaults, generally those default rates peaked at somewhere around 10%. And if you look over the last several years, the high-yield default rates, this is the yellow, it's been, call it, low- to mid-single digits, Moody's had said that in May 2020, to May, a couple months ago, that default rates had hit close to five percent, and they're projecting them to get to 10% a little bit later on in the year.

Now one important part of distinction when we talk about defaults, is that just because a company defaults on its bond doesn't mean that the bondholder automatically gets zero. And as I show here in this bullet point, you'll see that there are three types of defaults. There's obviously Chapter 11, which people know about, that's about 28% of defaults. Then there's the case where companies will stop paying their interest or might miss their principal payment. That's about another third. Then you have, what are called distressed exchanges. And so, example of that would be Tupperware. Tupperware had a rough first quarter, and its bonds traded all the way down, it had been rated investment grade, bonds traded all the way down to the high 20s. But then, the company had a couple of tender offers, and it bought back about $100 million of bonds at about $0.57 on the dollar. That was deemed a distressed exchange because bondholders were getting less than par. But the fact that they were able to pay down that level of debt at such a discounted price has made the financial strength of the company better, and now the bonds are trading up in the low 90s, so just because a bond is deemed to be default, yes, generally it's not good news. But it doesn't always mean that it's a zero percent recovery for bondholders.

Richard Carter: Right.

Steve Shaw: And what's important is, is that we want to put these default rates into perspective. Because again, you'll hear the default rates are 10%. Well, what does that mean? So, you remember from the previous slide that that's 10% of the high yield market, but we need to put that in the context of the overall bond market. So, if I were to go on Fidelity today, I would see about 7,200 ballpark CUSIPs, investment grade corporate bonds, okay? That default rate, if you remember from the previous slide in 2019 was about 0.05%. So, if we factor in that 0.05 default rate, it's about four CUSIPs out of 7200. We then look at high yield, and high yield market's a lot smaller than the investment grade market. Here you've got about 1,250 CUSIPs that you'd find on Fidelity, and if we applied a 4.7% default rate to that, it's about 59 bonds. This was at the May 2020 rate.

Now if we translate that into a worse performing time, and we go to the '08 default rate, so that's where the default rate for investment grade was at 0.03%, that would imply 22 out of the 7200. And then if we assume 10% out of all the high yield bonds, that's 125 out of the 1250. So, we're still talking about a fairly small portion of the overall universe. Out of these close to 8500 bonds, we're talking about 150. So it's still a small part of the universe, but that being said, investors still need to be careful in that, especially over the last several months, you've had companies that had really strong balance sheets, Southwest Airlines -- a perfect example, great balance sheet, but then bookings went down to close to zero, and it's an entirely different ballgame. So, two things that are important. First, the default rate is still small relative to the overall part of the market, but you still need to be really careful.

Richard Carter: Great. Okay, so I mean this is an interesting chart to see the distinction here between the default rates of investment grade and high yield. High yield obviously below BBB- and into the BBs and below, maybe a euphemism for high risk. You should be saying here, "aim for quality," if you do that, and stay for investment grade, for example, aren't you back to square one in terms of that hunt for yield? You're going to be paying for that quality in this environment, and you know, there's, I mean maybe there is no -- as we say, there's no free lunch, right? It's just hard to compete against stocks again with their better yields if I'm sticking to the lower chance of default here.

Steve Shaw: Sure, and the thing is, is that investors need to not just look at yield, because anytime that we look at a bond, obviously, we want to understand the yield, we compare that to other corporate bonds that are out there in the marketplace, but we're also looking for capital appreciation which we hope to be an even bigger part of the return. But if we do focus on yields specifically, and so these two charts, these are from Fidelity, and you'll see this is the treasury versus the corporate A yield curve, so this is showing the, in blue, the yield curve for A-rated corporate bonds, and you'll see that, if you are looking for some yield, and this is, on the x-axis you've got time to maturity. So, if you're looking for yield, if you only go out five years, it's nothing extremely compelling; you're looking a little bit north of 1%. But, you know, if you were to go out a little bit further on the curve, you'd get to close to 3%.

Now, if you then look at the BBB curve, it's a little bit of a different story, because you've got higher yields across the different maturities. Now, one thing that I've seen from many investors is that many investors will be concerned about going out too far in the curve. Now the challenge is, is that for investment grade corporate bonds, generally, investment grade corporate bonds are able to issue bonds with a longer term to maturity. Could be 30 years, 40 years, sometimes 50 years, and the thing is that, if you can deal with the prices going up and down, and a price going down 10 points or down 15 points, first you get the extra yield, but the other thing is that, let's say, worst case scenario, the company went belly up. If you own two bonds and one's due in 2022 and one's due in 2042, those bonds are what are called *pari passu*, so they rank equally. So, it doesn't matter that your bond is due earlier; it just matters where it's ranked. So, you're going to get the same recovery. It's just that you have to be able to stomach the higher price volatility with these longer-dated bonds, or you can dip a little bit lower in the credit spectrum and go into BBB or some high yield bonds.

Richard Carter: Interesting, right? And you have that flexibility with bonds. Same company, but a range of maturities.

Steve Shaw: Then what's helpful for folks to understand is that when we saw price volatility happen in the wake of COVID-19, it wasn't just limited to high yield bonds. You had, and in fact it was even in the treasury market where we had significant volatility. But this is an example of an Apple, so you've got Apple 4 3/8 of 45, so Apple's one of the highest credit quality companies out there; it's got over $200 billion of cash. Now, if you look at this chart, so this is the chart from Fidelity, and you look at the beginning part of the year, so this is, the bond was priced at 121.83 on January 2nd. And you then see how it ticked up, went all the way up to $135.91, and that was as COVID-19 was starting to set in. Then you had all the bad stuff start to happen, so you had on March 11th, the Dow entered bear territory, and that's when the corporate bond market effectively reached a bottom on March 19th. Now, the Fed took a fair amount of action, so first, March 3rd obviously got the Fed funds rate down to half a percentage point. It then started significantly increasing its balance sheet, bought all sorts of treasuries, took its balance sheet up from $4 trillion to $7 trillion, March 15th, cut the Fed funds rate down to zero, and then at one point we'll talk about a little bit later, it announced a corporate bond buying program for up to $750 billion, and what happened with all these actions is that it caused -- it stabilized the market, and it caused this bond price in particular to go back up, close to where it was before.

And what I say, the moral of the story is that, hopefully COVID-19 is as close to one of the worst situations that investors have to go through. But when we were going through COVID-19, we were not sellers; we were buyers. And it's important for folks to create, I'd say, a list of maybe three to four bonds, and perhaps Apple's one of the bonds, and Microsoft's another one of those bonds. It's bonds that are, I would call "bulletproof," and so that if something like a COVID-19 crash is to happen, you can have those in your back pocket and then if the market really goes down, it goes down 20/30 points, you can be proactive, you can go and you can be a buyer, and you can see the types of returns that folks are able to make in this case. And this is, we're not talking about a B-rated bond; we're talking about a AA-plus rated bond, an extraordinarily high credit quality bond.

Richard Carter: Yeah, that was a great example, Steve. Thank you for showing that and starting to feel that those occasional market shakeouts inspire, certainly requires a certain fortitude and clarity of mind. Ultimately, it's a judgment call, of course, when it's that right time. But I know you've got a great sort of analytic device coming up, or lens if you like, that could help people navigate a bond's price and yield, and dissect it, and helping them understand or figure out when is that value compelling. Would you mind just walking us through that here?

Steve Shaw: Sure, absolutely. So on slide 11, now if folks attended the last Fidelity webinar that Richard and I put together, there was a whole explanation in terms of what causes bond prices to move, and the makeup of a bond's yield-to-maturity, I'm just going to review that very quickly. So when we look at this Apple bond, and so we see, these are different dates that we took the price of the Apple bond, so January 2nd, March 9, March 19th, June 15th, those were similar to the prices that we looked at on the previous slide.

Now on January 2nd, the bond was priced at 121.83. Now, the yield to maturity in this case was 3.12%. Now If folks remember, that yield to maturity has two components. It has what we show here in blue, which is the benchmark Treasury yield to maturity, and all that is is there's a Treasury bond that's due right around when this Apple bond is due in 2045. On this date, on January 2nd, that bond had a yield to maturity of 2.26%. But the Apple bond had a yield to maturity of 3.12%, so the difference between those two numbers is what's called a credit spread, in orange, which is 0.87%. It effectively tells you the extra compensation that a bondholder is receiving to accept risk higher than that of the US Treasury. So as Apple's credit quality improves, that credit spread should shrink, as if there's market turmoil, that credit spread will increase or widen.

Now if you think about what happened over those few months, as I showed on the previous slide, the bond had actually started going up in price at the beginning part of the year. And the reason why that happened, so it went from 121.8 all the way to 135.91, was because people were having a flight to quality. And so, as people were buying more treasuries, you had the Treasury yield go from 2.26% all the way down to 0.93%. Now, Apple's credit spread, because of everything that was going on with COVID-19 actually increased; it doubled from 0.86% to 1.52%, but because the Treasury had gone down so much in yield, that's what drove the price of the Apple bond. So, it took the yield to maturity from 3.12% down to 2.45%, and it took the price all the way up to 135.91.

Now, then COVID-19 really set in, and you had lots of fear in the market, and this is the case where you even had, first you had Treasury yields even spiked up, because there was a lack of liquidity in the Treasury market; people were just, they were staying away from treasuries at that point, and you had credit spreads increase significantly because people thought the world was coming to an end. So, you had the credit spread go all the way up to close to 3%. And generally, historically Apple's credit spread for a bond that's due in 2045 is close to 1%. So, any time you see a credit spread go that high for a bond such as Apple, you know things are a little bit haywire in the market. And then the Fed stepped in, and the credit spread shrunk, the Treasury market calmed down because the Fed started buying treasuries. And then you had the yield to maturity shrink all the way back down to 2.63%, and you had a 35-point rally in the bond. So, it's important for folks to understand what drives those pricing changes.

Richard Carter: That's fantastic, Steve, thank you very much. Really helpful to see it like this. May, if I could, I'd like to dive a little bit deeper on the steps between numbers 2 and 3, the last part of this here, because it's incredible to see that you have yield compression on the treasuries at the same time as you had spread compression, you know, sort of flight to safety with treasuries being in stronger demand to yield falling and also yet a risk, as you said, a high quality risk with Apple but still a risk of bond, a corporate bond, also spreads climbing. So, this is just to explain the dynamics at work there; that seemed to be a surprising step there.

Steve Shaw: So we obviously, we had the Fed come in, and due to things that we talked about before in terms of increasing its balance sheet, so in terms of increasing the balance sheet, that's what stabilized the Treasury market, because a significant amount of the money that went to increase the balance sheet was to buy treasuries. So, it bought treasuries, the price of treasuries went up and the yields dropped. The Fed also announced these corporate bond credit facilities, and that's what we show here on this slide, and so these were put into two different buckets. So first there was one that was called PMCCF and another was called SMCCF. The difference between the two is that PMCCF is the primary corporate bond credit facility, and the SMCCF, so those are for new issues. And the secondary market, those are bonds that are already trading; that's called SMCCF. And the Treasury put -- allocated $75 billion of this, and then the Fed could lend up to a multiple of ten times to buy these bonds, and the multiple depends on the credit quality of the bond.

But what's really interesting is that the Fed announced this program, but then as we show down here, on PMCCF, there have been no transactions. So, the Fed has not bought any bonds with, in the primary market. And even in the SMCCF, where there's $250 billion of potential facility there, through June 30th, it had only bought $8 billion in corporate bond ETFs, and $1.5 billion in individual corporate bonds, so the Fed indeed carried a big stick, but it hasn't really had to use it, because the market, the Fed had made the announcement, it had the facility, so it's effectively there if markets were to go haywire. But then the markets stepped in, and that's what's helped buoy many corporate bond prices. And if you look at some of the things that have happened, one of the things that I alluded to earlier on in the presentation was how companies such as Southwest Airlines and Macy's, because of the intervention of the Fed, the capital markets have continued to work, and you've had huge levels of corporate bond issuance, and just to put that into perspective, Richard, you look at, this is on the left chart, annual corporate bond issuance. And you'll see that in 2019 it was a little bit south of $1.2 trillion, and 2017 was a record close to $1.4 trillion, and that's investment grade; it's obviously a lot lower for high yield. But then you look at it for the last two years, and specifically the beginning part, or the last three months, and you see the huge level of issuance; you've got close to $250 billion in March, 275 in April, and then a little bit north of 250 in May, so you've almost got three-quarters of a year worth of issuance in one quarter, and that's helped a lot of these companies live to fight another day, but it's shown the strength of the Fed, that the action of the Fed has taken, and what impact that's had on the markets.

Richard Carter: Great data, I mean really, what an exceptionally fast period we've been living through, as you say, first the Fed stepping in, as much verbal power as actually having to spend the money, and it's led to that great refinancing opportunity for so many companies, as this chart shows here on the far right.

I'd like to change gears, if I may, Steve, now, and ask if you could share with our audience a little bit more detail on your research process that you and BondSavvy engage in, and I know you've prepared some excellent case studies for us to look at here, and I'd like to start then, as you were showing here, with one major theme that I know we hear a lot about from our investors, and that is the growth of the BBB part of the investment grade, again back to your chart even on the previous slide there, the BBB part of the market has driven so much of the issuance, and this notion that that's a very crowded space, and beware, if you like. So how would you set about navigating this segment of the investment grade market and deciding what's good quality and what is best avoided?

Steve Shaw: Sure. And ultimately what we're looking to do, Richard, is we're looking to find value. We're looking to find companies that have strong financials, but perhaps the bond is misrated and has a higher yield relative to other bonds that are out there in the marketplace, and we obviously go through a bunch of other factors; we're looking for financials of the company, we're looking at upcoming maturities, comparing credit spreads to other bonds. But this is a perfect example in terms of where to find value, and also where not to find value in corporate bonds. So, in many cases, you'll turn on CNBC and people will say, the BBB market, it's just a mess. And as with virtually any stereotype, or any type of generalization, they're generally wrong, or they're going to be wrong for a wide variety of specific bonds in this case. And so, what we've done here is we've compared two bonds that have similar ratings. So, you've got Kroger, which is Baa1, BBB, Anheuser-Busch InBev, which is Baa1, BBB+, so it even has a higher rating than Kroger by S&P. And we compare the financials. So, they both have several billion dollars of cash

But then we get into the nitty-gritty, okay? So how much debt does each company have relative to its earnings? And so, you look at the total debt of each company. Kroger's got $12.6 billion, AB InBev has $101 billion, and then you compare it to the EBITDA. So, remember, folks remember from the last presentation, EBITDA is Earnings Before Interest, Taxes, and Depreciation, so everybody's heard of net income. Here we want to try to understand before the company pays its taxes, before it pays interest, and before non-cash items like depreciation/amortization, how much cash does it have coming in the door to service this debt? And so, this is a case where Kroger, for the last 12 months at EBITDA of $6 billion, and AB InBev had about $20 billion. And one of the key ratios that we look at is leverage, because that gives you an idea of, okay, how much debt relative to the cash flow of the company is there? So obviously, the higher that leverage ratio is, the more risky the bond is. So here you've got Kroger that has leverage of 2.1 times, and AB InBev that has leverage of 5.1 times, and you then look at the trajectory of the business, and the grocery companies have just knocked it out of the park over the last several months, as many would expect. And AB InBev, because it's obviously selling a lot into restaurants and bars, it's taken a hit. And so, its revenues are down; it's EBITDA is down. So this is a case where you'll see a rating, and many people will just believe, it's a BBB, so either they'll believe it's pretty safe, or they'll think, well, all BBB are risky, and this is a case where there's a significant difference in two BBB bonds, and it happens fairly regularly. Oftentimes you'll even see bonds that are rated below BBB that can have financials that are superior to an AB InBev.

And the question is, well, how do we get here? And here's how, it's important for folks to understand, you'll see a rating. And then the question is, is well, how is the rating calculated? And I don't think, many investors may not necessarily appreciate how it all works and what kind of goes on behind the screen, but this is the ratings methodology employed by Moody's, and for different industries. So, it shows the retail industry on the left side of the page, and then the alcohol beverage industry on the right side. So retail, that's obviously where Kroger falls in. Alcoholic beverages were AB InBev. Now, they weigh different factors, so you'll see here for retail, the ratings for companies within the retail industries are weighted the following: you've got scale, so that's just, you'll see here, revenue, so how big the company is, that's 10%. You then have what's called "business profiles," they refer to stability of the product, competitive position, those sorts of things, is 30%. And then you have the nuts and bolts, the leverage and coverage, which we talked about before. We talked about leverage; interest coverage is just how much cash flow the company has relatively to its interest expense. And here, it's weighted 45%. So pretty significant part of the rating. The last piece is financial policy, and all financial policy is it's saying, okay, if a company has a billion dollars of cash coming in the door, what's it doing with it? Is it just putting it in to share repurchases? Is it just putting it in to dividends? Is it doing M&A, mergers and acquisitions, or is it paying down debt? And so, all these things factor into a bond's rating in retail. And I would believe that this is a fairly fair way to look at it, because it doesn't just look at leverage and coverage; it is looking at some other things.

Now, when you compare that to say, alcoholic beverages, here, leverage and coverage is only 30% of the story. So, you can have a high leverage ratio, but since it's only 30% of the weighting, it effectively gets underweighted, in my view. The things that are weighed more heavily are things such as scale, and things such as business profile, so here you see things such as diversification, innovation, distribution, infrastructure; I would refer to those things as fairly fuzzy type of metrics, and they're really hard to gauge. And the fact that such a huge part of the rating is based on these fuzzy metrics, it effectively gives corporate CFOs a guidebook as to, okay, if you make a company like this, you'll be able to have a high rating. So, get big, be diversified, be global, even if your leverage ratio is through the roof. And what I'll say is that, it doesn't really matter how well, how much a company's brand is, or how solid the company's brand is, or how many markets it's in. The company has a 5x leverage ratio. If there's a little bit of a hiccup, that company's going to be in trouble. And so, that's how, you see situations like this where companies have the same rating, but they're actually vastly different terms of their overall credit quality.

Richard Carter: That's great, Steve, really good lessons there, and thank you for taking us sort of behind the scenes of the rating itself. On that note, let's move to our second case study, another interesting one I think here. We've seen the case of a company that has been downgrading losing its investment grade status. So as an investor, you know, I could obviously just wait and be informed by the rating agencies, and we at Fidelity make sure our investors have that information and changes in that ratings at their disposal. But maybe you could walk us through here some of the telltale signs, that might be a little red flag you know, ahead or at least alongside the rating agencies' thinking as well.

Steve Shaw: Sure. And what I've shown here is this is Macy's. And what we're showing here is the company's balance sheet and some income statement information over time. And so, we look at, and Macy's, like many retailers, they report their year-end, it's the first Saturday of February, because they want to get all the holiday season in and returns and all that kind of thing. So, February 2nd of 2019, the company was in pretty good shape.

So, you'll see that the company had about a $1.1 billion of cash. It had senior debt capacity, meaning that it had the ability to draw down on these senior bank lines of $1.5 billion, but none was outstanding. You had about $4.6 billion of bonds, and you had pretty strong earnings, so you had $2.9 billion of EBITDA, so you had a leverage ratio of 1.6 times. If you netted out the cash from that, you have a net leverage ratio of 1.2 times. That's a really strong balance sheet. Anything less than 2 times generally signals a very strong balance sheet. You then fast-forward to the beginning part of this year, and so the year ended February 1st, 2020. That's actually their fiscal '19; most of the earnings took place during the calendar year of 2019. Now you had a little bit less cash, but you still didn't have any senior debt. And they had actually paid down close to $1 billion of bonds, and from a bondholder's perspective, this was pretty good because if things go wrong, it's nice to know that in this case, there was no senior debt that was in front of you, so that, if let's say Macy's went belly up, you'd be the first in line, because you had $3.6 billion of bonds outstanding, but you didn't have anything outstanding in terms of senior debt. Now, then the company reported earnings on May 2nd, or for May 2nd, actually did it on July 1st, and that's where you had some bad things happen. So here, remember, in number two, there was no senior debt.

We then fast-forward to May 2nd; they drew down $1.5 billion on their bank loan. So, you then had $1.5 billion that's senior to the bondholders, and they also incurred, they also issued more bonds. So now you've got total debt of $5.6 billion. Then the double-whammy is, Q1 was just awful, so trailing 12-month EBITDA went from $2.3 billion all the way down to $1.2 billion, and so you had leverage go from 1.5 to 4.7. Now, because they drew down, their cash balance increased, but obviously, they'll burn a decent amount of cash. Now, since stores have reopened, they're starting to get profitable. J.C. Penney actually just announced a very profitable month, and but this is the thing, in that luckily, Macy's had really low leverage before COVID-19, and it enabled them to weather the storm. So now leverage is at 4.7 times. If they had gone into COVID-19 having leverage of 4.7 times and then they had to shut down the stores, they would have likely filed for bankruptcy. That's why when we look at these leverage ratios, it's so important to have some wiggle room, especially when you have events that happen such as COVID-19.

Richard Carter: And I think you're showing, Steve, be aware of that senior debt borrowing capacity, right? I mean, even if it's not exercised, it is a potential risk.

Steve Shaw: Yeah, and every company, virtually every company will have it, and they'll report how much is outstanding the report, how much has been drawn. But a lot of things happened with Macy's. First you had the senior debt. And actually, what was interesting is that for these bonds, none of the stores were collateral for the bonds initially, but now that they had to have more senior debt, now many of the stores are encumbered by bonds, and other sorts of debt. So, you always need to know what's out there and what's lurking.

Richard Carter: Thank you, great. Okay, so now let's move forward to our third case study, we're looking at a company that has gone through bankruptcy. I know it's impossible really to generalize, but what would be some of the key considerations to look at when deciding either to invest or stay with a company in terms of investor that is struggling, has struggled through bankruptcy?

Steve Shaw: So, this is a bond, Monitronics, nine and 1/8 of 20, and this is a bond that, it was one of the first recommendations we had made, and it was back in September of 2017. Now the interesting thing about Monitronics, so Monitronics is a home security company, and while these bonds were due on April 1st of 2020, they had a lot of senior debt in front of them. So, they had about a billion dollars of senior debt in front of them, and that senior debt was subject to what's called a "springing maturity," and what happened was, these bonds needed to be refinanced six months before they were due. So, they needed to be refinanced by October 3rd, 2019. Otherwise, all the billion dollars of senior bonds came due on that date.

And so, we knew that this company was fairly high-risk, because if the bonds weren't going to be refinanced by then, then the company was going to have to file. And so, this is the case, anytime we make a recommendation, we follow religiously anytime the company reports its earnings, or any significant event that happens with the company. Monitronics was no different, so every time the company reported its earnings, we wanted to get an idea of, okay, is the company turning the corner? And this is a case where the company continued to report poor earnings. It then had; it made a tender offer. It was right around kind of mid-70s, and there was a fair amount of activity in the bond, and because the company just wasn't turning the corner, that's when we decided to sell, because for a company like this, the key considerations, or two considerations in this case was first, could the company pay down the bonds? Well it didn't have the cash, so it was going to have to refinance the bonds. Now it could refinance the bonds if its financials were strong, and it could get buyers for those bonds, but if the financials were weak, it would be really hard to attract new buyers for the bond. So, and all sorts of discussions with bondholders and the banks, and it just wasn't able to do anything, and this is the case where we decided to take a loss. So recommended the bonds around 89, and we sold them around somewhere in the mid- to high-70s, so we lost about 7%. But then, the company wasn't able to successfully restructure, and the bonds just kind of kept going down and down, and the company filed for Chapter 11 in July 1st of 2019.

Now, what's interesting in this case study is what all happens when we're going through it, and what it means for bondholders. And so, this is the case where we look at Monitronics. So, this was the company's balance sheet on July 1st of 2019. So, you'll see that the bonds that we talked about, so they had

$585 million of bonds. They then had about $1.1 billion of senior bank debt. Now, the company filed for bankruptcy. So, what happened was is they had this, what's called debtor-in-possession financing, so DIP financing. That then came in, that was $245 million. That effectively holds the company over while it's going into bankruptcy. And the question is, is okay, for bondholders, what does that mean in terms of recovery? So, the way that it worked was, once the company goes into bankruptcy, a couple things need to be figured out. So first is, what's the value of the company? That's driven by what type of returns, the financials of the company, and you look at what multiples the company might trade at. Then the question is, what's the sustainable level of debt that the company can have? Because, the last thing we want is to put the same level of debt on the company that caused it to go into bankruptcy. And as a result, a lot of debt gets wiped out. That's exactly what happened with Monitronics, so here we had the bondholders, $585 million, they were given a little bit.

So, they were given $75 million of value in shares of the new company, and a measly $2 million of cash. So, they got $77 million total, so recovery of about 13.2%, and even that's a little overstated, because a lot of that was in stock. The senior bank folks, so the term loans, they did okay. So, there are new term loans that are coming into the company of $823 million. You then got new coshares of $100 million, and then they got cash of $150 million, so it just shows how important it is to know where you are in the capital structure, because this is a case where if there was no bank debt, there would have been a decent recovery for the bondholders. But because you had so much bank debt on top of the bonds, it led to fairly poor recoveries for the bondholders.

Richard Carter: Thanks, Steve. Okay, well great points. So, investing in corporate bonds in unprecedented times. Let's end where we began, if I may, what key thoughts would you like to leave our audience with today?

Steve Shaw: The first thing is to dial down the risk a little bit, and to focus on companies that you generally feel you've got leverage of three times or less; you can even go up to four times in some industries, but I'd say, try to be fairly conservative when it comes to that, rather than something that's extremely highly-leveraged, especially in COVID-unfriendly industries such as cruise ships and those sorts of things. The next thing is just, you have to monitor. When you buy a bond, yes, bonds are safer than stocks, but there still is risk, even for highly rated bonds, the fortunes of companies can change fairly quickly. And so, what we do is we always monitor companies; we monitor the financial performance of companies to get an idea in terms of, has the game changed at all? We want to know what level of debt is senior to us, because if there is a problem with the bond, and there is a default, that's obviously going to impact our recovery, we talked earlier about how important it is to have a list of the Apples, the Microsoft, those sorts of companies so that if things do go haywire, and bonds fall significantly, to have those in your back pocket and take advantage of that. Discipline is really important; I like to refer to Warren Buffet. There are no called strikes investing, so what's happened is that you've had lots of bond prices go up significantly. And so, if someone's new coming into corporate bonds, invest over time, because many bond prices right now are inflated; you want to be selective. Just like a stock portfolio, we want to be careful with our industry concentration.

And then, if it is a hard-hit industry, get an idea in terms of how much cash runway it has, and will it be able to withstand what's going on in the market right now. And the last piece is, is that, and this is a lesson learned, if you do decide to go down to a bond that is very speculative, what you want to do is mark the key events that are happening in that company. So, when's the next principal repayment due; when's the next interest payment due, and make sure that the company actually does that. Even if it's a small interest payment, make sure the company pays that before you invest, because even if it's a small interest payment, it still can't favor that interest payment over another interest payment that might be for a senior piece of bonds. Just make sure that that stuff happens before you invest, another rule of the road, if you will.

END OF AUDIO FILE
