TRANSCRIPT

Corporate bond investing for total return

Presenters: Richard Carter and Steve Shaw

Richard Carter: Welcome, everybody, to our bond investing webinar. We're delighted today to welcome back Steve Shaw to our webinar series. Steve is the founder and president of Bond Savvy, which is a research service -- it specializes in helping individual retail investors invest in corporate bonds. Steve's a 24-year veteran of the financial markets. He's worked in corporate mergers and acquisitions, as well as -- he headed up for a while the bond trading venue Tradeweb Direct, which is one of Fidelity's partners in sourcing our bond inventory. Steve founded Bond Savvy in 2017.

So Steve, it's great to have you back. I think it's becoming a bit of a regular event in the summertime, so many thanks for that. It's been quite an extraordinary year, hasn't it, all round? When we spoke about a year ago, of course, we'd just come out of quite an abrupt sell-off in March of 2020, and the markets as well as the corporate bond market was already well on its way to recovery. And then since then, we've seen corporate bonds have a very strong year in 2020 all round -- the investment-grade index was up around seven and a half percent, and that was on top of a very good 2019, with an eight-plus-percent return. So with that as a backdrop, I mean, that was fantastic performance for bond investors. Doesn't that present a bit of a dilemma for people looking at now the bond investing landscape, searching for opportunities? High prices, low yields -- what does one do?

Steve Shaw: Yeah, and first, Richard, thank you and Fidelity for having me on again. It's a pleasure to be with everyone, and thanks to everyone for joining it. It certainly has been more challenging to find opportunities, but if you think about what happened the latter part of last year and into this year, when you had treasury yields rise, there are actually some really nice opportunities in investment-grade bonds. Some bonds of some of the world's greatest companies had fallen to as low as 80 cents on the dollar. So one of the things we're going to talk about today, and the focus of this presentation, is total returns and how we maximize total returns. And a big part of that is being flexible and investing in bonds that folks may not have been willing to invest in in the past.

So to kick it off today, Richard, what we're going to start off with is this graphic here. And I think many people, when they think about bonds, you know, they hear that word and they just think, well, all I'm going to do is I'm going to clip a coupon, and the only thing that I can get here is a yield, and when I invest in bonds, all I'm thinking about is stability and so-called "ballast." But we look at it a little bit differently. Now, when you look at these three different investment criteria, which are extraordinarily important, I think, for most investors -- generating income, reserving capital, and driving growth -- and when you compare individual corporate bonds to other types of investments, when you look at stocks and you look at bond funds, with individual corporate bonds, you can achieve all three of those. With stocks, yes, you can drive growth, and yes, you can drive more growth with a stock than you can with a bond, but you're generally not investing in stocks to preserve capital. And as we saw last year in the wake of COVID-19, you had scores of companies, some really strong companies, either completely suspend their dividends or slash their dividends. So the income you can't really -- can't always count on. And with bond funds, yes, you can generate income, you can preserve capital, but as they'll show in a little bit, you're not going to be able to, generally speaking, achieve growth in terms of capital. So it's important for folks to think of that. And obviously the title of the presentation is Corporate Bond Investing for Total Return. And when we think about how we achieve those total returns, there are -- in our view, there are four different keys. And the first is that folks need to be flexible, and that -- when I talk to investors, many people will say, "You know what, I will never invest in a bond that has maturity longer than ten years, and I'll never invest in a high-yield bond, even though the rating agencies don't always get it right." But we believe it's important to consider a wide variety of bonds. And we're going to explain why that is and we're going to explain how different bonds react in terms of different things that are going on in the market, and why you should consider -- potentially consider a wider variety of bonds.

We're looking for value. And we're not just looking at what is the bond yield and what's the coupon, but we're looking to find bonds that are trading at a compelling value, ideally below par but not always below par. We were able to find lots of really great bonds below par in this year. But we want to find value -- we want to find bonds that can increase in value. Monitoring them is extremely important, because just because you buy a bond today -- the world is going to change. The world is going to change in three months, it's going to change in six months, it's going to change in a couple of years, and it's important to continually monitor not only the price of the bonds that you buy but also the financial performance of the bonds, and that's what we do. And ultimately, you have to decide, okay, well, when are we going to sell a bond? Because as I'm going to show in a couple of slides, bond prices have ceilings. Bonds can't go up forever like a stock can. And so it's really important to consider a number of factors and ultimately sell bonds prior to maturity to maximize the total return of your investment.

Richard Carter: Thanks, Steve. Well, this sounds like good advice, you know. Do your research, look for value, and then when you've purchased something, monitor it. I think we'd all agree there. But I think what is different about your approach is a bit subtle. And so this idea of selling before maturity, I think our listeners would be interested to hear more about. How do you begin this journey? I mean, there are a lot of bonds, and of course, many companies issue many bonds, right? So you've got a huge universe. How do you begin to, again, embark on this journey of looking for that value and then proceeding with the rest of your process?

Steve Shaw: Sure. It ultimately comes down to, Richard, understanding the financials of the company and getting an idea in terms of where different bonds are trading relative to other bonds. And we'll talk a lot in detail in terms of how we ultimately cull the universe as we move further in the presentation. But one of the most important things for investors to understand is effectively the goalposts of prices of corporate bonds. And what we show here is the -- we show the pricing distribution of a bond search that we did on fidelity.com back in May. So this was investment-grade corporate bonds; we had 8,000 corporate bonds for investment-grade, and there were 1,100 high-yield corporate bonds. And what we show here is we show the pricing distribution based on how the bonds are quoted in terms of the dollar price. So you'll see that the bonds -- for these 8,000 bonds, you had -- there was one bond that was priced lower than 80; for investment-grade, you only had --you had 55 bonds that were priced greater than 150. So it shows you that with investment-grade corporate bonds, there's a decent amount of price variability, where you've got some bonds priced in the 80s, you've got some bonds priced fairly high, and so there's an opportunity for an investor to make a nice return within that band of prices. On the high-yield side, you'll see you also had a decent amount of pricing variability, but a key difference is that here in investment-grade, for bonds that were priced from 125 to less than 150, you had 1,000 bonds, so about 12.5% of all the investment-grade corporate bonds, whereas in high-yield it was only 5.3%. So the important thing to understand here is that what we see from this chart is as prices get higher and higher within a certain bond, the likelihood of that bond continuing to go up decreases. Because bonds have all sorts of provisions. Bonds have maturity dates. Bonds have coupons. They've got yields, and all those things, which, in the end, constrict how high a bond can go in price. Now, people will ask, "Well, how can -- why would an investment-grade bond go higher than a high-yield bond?" And the reason for that is, and one of the things we're going to talk about a little bit later, is, first of all, investment-grade bonds typically have a longer time to maturity, so you've got greater pricing volatility, and then they have different call provisions compared to high-yield bonds. So what's important for folks to understand is, we love to buy bonds down here. So, you know, these bonds that are priced below par, especially when we could buy those bonds at 85 cents on the dollar a few months ago -- and then ideally, we're going to hold those bonds, we're going to monitor the financial performance of the company, and -- but as that bond goes up in value, let's say we buy it at 90 and it goes up to 125, we're going to start thinking long and hard about potentially selling that bond.

Now, many bond investors, they think, well, I'm just going to invest in shorter-dated bonds, because I don't want to go into my Fidelity account and see red, and see, okay, you know, the price has gone down 5% or it's gone down 10%. But what's important for folks to understand is that you can use volatility to your advantage, especially when we're talking about highly rated bonds. And what we show here on slide seven is we compare US treasury yields to an Apple bond. So this is Apple 3.45s of 2045. And just for folks to keep in mind, treasuries are typically quoted on a yield basis, so when you hear the 10-year treasury is at 1.18%, that's obviously the bond's yield to maturity. What we show here on the left chart is the 30-year in gray, the 10-year in orange, and then the one-year in blue. And we see how volatile these treasury yields have been. They went down in the wake of COVID-19, and they did a pretty strong increase, but then they've fallen again, to the surprise of many investors. When you look at this Apple bond, now, people would think, "Well, Apple's an incredible company. We have some of the metrics here -- it's got $200 billion of cash and only has $100 billion, $120 billion of debt. Virtually no risk of default. Why would the bond ever be so volatile?" And the bond's volatile because, as we'll show a little bit later, this bond's performance is largely impacted by movements in the treasury market. You'll see, as treasury yields were increasing here, the price of the Apple bond fell fairly significantly. It fell from -- call it 123 all the way down to 105. And think about it. Think how strong the performance of Apple as a company has been. It's been extraordinary. And as a bond investor, earlier in the year, you could buy that bond at a 15% discount to where the bond was trading. You couldn't do that with the stock. And so it's just important for folks to understand that you have those opportunities in these long-term bonds, and this is a case where you don't have to worry about a default. There's a big difference between a short-term loss in value of a bond and permanent capital loss, and we'll talk about that a little bit later on.

Richard Carter: Thanks, Steve. That's fascinating. Yeah, I mean, it really does show you, doesn't it -- I mean, just to recap here, then, you've got the yields moving down in the treasuries in the spring, and then prices moving up. And they're -- the Apple bond falling. And it does -- as you said, it's an extremely strong-quality company; I think people must be scratching their heads, wondering why this is happening, right, when the business results are so strong.

Steve Shaw: Yeah, and that's driven by what's going on in the treasury market, and we'll talk about why this Apple bond was so sensitive -- so when you had treasury yields increase from the latter part of -- well, actually, the large part of last year, and then -- and why that had such a big impact, we'll talk about that as we move a little bit further on. But one of the interesting things, Richard, is when we talk about the types of investments that are available for bond investors out there, and where you can achieve capital appreciation -- so we showed the Apple bond in the last slide. And so here, what we're doing is we're comparing US treasury yields -- these are the same treasury yields that we showed on the previous slide, but then we compare it to Vanguard Total Bond Market Index Fund, a $300 billion fund. So a massive fund that owns 10,000 bonds. And you'll see here that the pricing variability is fairly muted. Even in the wake of COVID-19, there was still -- yes, I mean, it did fall from -- call it 11.60 down to 10.80, but even when treasury yields spiked -- and this fund is heavy on treasuries and mortgage-backed securities and other things that are sensitive to treasury yields -- but the bond, this bond fund hardly fell at all. It fell about 5%, even as treasury yields spiked significantly. So the choice investors have is that, if you're an investor who says, "You know what, I just can't stomach a bond, the value of a bond holding going down more than a few percent," then sure, a bond fund like this could work for you. But if you're looking to find an advantage where a bond such as Apple, Apple '45s, have fallen 15%, you've got a really nice opportunity for strong capital appreciation in those bonds compared to what you have in a large bond fund.

Richard Carter: Yeah, and I see that, Steve, right, that you've got on this chart to the right -- the average maturity of this fund is just eight and a half years, so that would tend to indicate, right, it's going to be less volatile typically, right? It's a bit more -- we're between the lines on the left, a bit more like a blend of the blue and the orange, where you're not quite as volatile as the longer date is.

But what other types of bonds are you considering, right? I mean, so there's the high-quality example. Presumably not all bonds are moving to that same trajectory.

Steve Shaw: Yes. And there's one other point that I wanted to make here -- when we're talking about value and finding the value of bonds, with the Apple bond, we were able to assess, okay, here's where the bond is yielding, here's what its credit spread is, here are the financials of the company. But when you look at this fund, such as this Vanguard fund, since it's priced off net asset value per share, it's not as if you've got metrics to look at in terms of, well, what's the value of this fund and how does it stack up to others? You can do a similar thing, in terms of finding value, with a high-yield bond. And what's even more interesting is that when we look at this high-yield bonds -- this is a bond that Bond Savvy had previously recommended, L Brand 6, six and seven-eighths, due in 2035. And so L Brands is the parent company of Victoria's Secret and Bath and Body Works; it actually just spun off Victoria's Secret. Now, we look at what happened with treasury yields -- so as treasury yields were spiking, this bond doubled in price. Now, obviously it struggled in the earlier part of 2020, because it, like other retailers, closed stores; people thought there was going to be all sorts of trouble with retailers across the board, and there certainly was with certain retailers, and so this bond fell from a little bit north of par down to 60. But Bath and Body Works, a big part of what they sell is hand sanitizers and soaps and all things to keep us clean and all those sorts of good things, and so this company reported extraordinarily strong financial performance. And so even in the wake of treasury yields increasing significantly, this bond doubled in price. Now it's priced close to 129. So what's important for folks to understand is that, yes, there are going to be times when people get down on bonds, and they believe, well, treasury yields can only go up, and that's going to hurt the value of all bonds. But high-yield bonds are, as we're going to talk about in a moment, they're generally not sensitive to changes in treasury yields, and they're more tied to the financial performance of the company. And in this case, the financial performance of L Brands has been very strong.

Richard Carter: Yeah, that's quite fascinating, Steve. So I think these price history charts really help investors to see that degree of price change. You know, these charts weren't available for a long time, and now, as you're citing here, they're available from FINRA. Their website, as well as fidelity.com, recently added charting. But from an analytical point of view, you know, how do you come to the broad array of bond choices and attempt to break down to what degree you think a bond will be sensitive to the movement of treasury prices versus its own performance?

Steve Shaw: So what we've done here, Richard, on slide 10, is we've taken two different bonds. So we've talked about the Apple 3.45s of '45, and I wanted to give two different extremes, so folks can get an idea of, okay, what really starts to drive bond prices, and what are some of the things that you can look at? So this was a previous Bond Savvy recommendation, Albertsons 7.45 to '29 -- it was actually included in the first set of recommendations we made in September of 2017. And what we've done here is, we've shown the components of these bonds' yields to maturity. And we've shown them across two different dates. So we'll first look at this Albertsons bond. So we have Albertsons bond on the date that we recommended it, September 26 of 2017. And then we also looked at it a couple weeks ago on July 15. And we wanted to see, okay, well, what happened to the bond price, what happened to the yield, and what was really driving it? And so when we look at the Apple bond -- so obviously this is one of the highest-quality bonds that are out there, rated Aa1, AA+. On September 26 of 2017, it had a price of 95.34. Now, on September 16 of 2017, the yield of the Apple bond was 3.72%, so the bond's yield to maturity. Now, that yield to maturity has two different components. The first component, and we're going to talk a little bit about this, is what's called the benchmark treasury -- the benchmark treasury yield. And all that is is -- it's a fancy name, but all it is is it's the yield to maturity of a treasury bond that has a similar maturity date to the corporate bond. So there is a US treasury bond that's due on or about when this Apple bond is due in 2045. And on September 26th of 2017, that bond had a yield to maturity of 2.78%. As you would expect, if you go from September 26 of 2017 to July 15th of 2021, that yield has gone down, as the treasury market has rallied and treasury yields have fallen. Similarly, when you compare the benchmark treasury on this Apple bond to the benchmark of the Albertsons bond -- so the Albertsons bond is due in 2029, so obviously a shorter time to maturity -- it had a lower yield to maturity.

So now it gets to the question of, okay, well, what's going to start to -- what things are going to drive the bond price? And when we look at this Apple bond, you'll see how significant the portion of the benchmark treasury yield to maturity is of the entire bond's yield to maturity. Now, people will ask, well, what's this thing in yellow called the credit spread? Not in yellow -- in orange called the credit spread? The credit spread is just the difference between the corporate bond's yield to maturity and that of the benchmark treasury. And what it shows is, it shows the extra compensation or yield that the bond holder is receiving to compensate it for the credit risk that's higher than the US government. Now, I'll argue that a company such as Apple, I don't believe it has materially higher credit risk than the US government, given the financials of both entities. But that's how the market works. And so here, the credit spread was .94%. So if you think about it, the yield to maturity here is about 70% of the total bond's yield to maturity. So if you think about the component, this bond is going to be more sensitive to what happens to the treasury market than what's going to happen to the Apple bond's credit spread. Typically, a credit spread can change a variety of factors. It can be first based on Apple's financial performance, but then also some overall market sentiment and fund flows into taxable bond funds and things like that. And that can impact where credit spreads are. But if we think about how this bond moved in price -- so it went from 95.34 all the way up to 113.32 -- it was driven primarily by the fact that treasuries rallied and treasury yields fell. Yes, there was a small decrease in the credit spread, but that wasn't the driver of the fact that the Apple bond went up in price.

Now, the Albertsons bond is a horse of a different color, in that when we look at what the credit spread makes up of the entire yield to maturity, it's a significant portion. It's 80+ percent. The credit spread was 8.46% out of the total bond's yield of 10.74%. So what happens in the treasury market does not impact what happens with this Albertsons bond. It's based on how Albertsons has performed. It's based on fund flows into high-yield corporate bonds. When we look at where this bond has gone, it was at 78.40 when we recommended it, it was at 117.54 a couple of weeks ago, and it's been the credit spread that's been driving this. And so, yes, these are two specific bonds that we selected, but when we look at the overall universe and we think about investment-grade versus high-yield, they're different drivers. So typically, for an investment-grade corporate bond, the benchmark treasury's going to make up a larger portion of that yield to maturity, so it's going to be more sensitive to what happens to treasury yields, and the maturity is typically longer. So that's also going to make those long-dated investment-grade bonds, such as an Apple bond, more sensitive to treasury, whereas the high-yield bond generally isn't.

Richard Carter: Yeah, that's fantastic, Steve, thank you. So really -- you've really broken that down for us here. I think it's -- you know, between the high-quality and the high-yield, or low-quality, shall we say, you've got those two extremes. And I think that within it, you're touching on this interesting issue of diversification, right? You're in this side, the corporate bond market slice of the bond market, but you're saying there's different ways to approach it and look at the different issues there from a diversification point of view. Could we elaborate that a little bit and say, you know, how else would you -- you know, you've got high-yield and investment-grade, but how do you look at sort of that broadening the mix of bonds that you might include in your service or in a portfolio?

Steve Shaw: Yeah, and it's really important to -- I mean, it's nice to look at these charts and get an idea in terms of, well, this yield versus that yield, but then the question is how does it translate into investment decisions, and constructing an entire portfolio? And what we've done here on slide 11, Richard, is we've looked at four different groups of corporate bonds. Group 1 -- so, group 1 through group 4: group 1 is short-term investment-grade corporate bonds; group 2 is longer-term investment-grade corporate bonds; group 3 are what are referred to as fallen angels -- so those are bonds that were initially rated investment-grade but then were downgraded to below investment-grade, and the benefit of some of those bonds is that they still have some of the benefits, in terms of upside, of a bond that's currently rated investment-grade, but the yield is a little bit higher, and we'll talk about that in a moment. And group 4 are high-yield bonds with near-term call dates. And we're going to talk in depth about call dates and call prices and how all those work. But when we look at our recommendations and how we believe investors should construct a portfolio, we generally rule out this group 1. Because -- unless if your time horizon is the next three to six months, we do not believe that these bonds are particularly productive, in that -- what we've done here, Richard, is we've evaluated the bonds based on four different criteria, upside potential and yield. And so if it is high upside potential and a higher yield, then it's a full battery; if it has lower potential, lower yields, then it's an empty battery; and then we also looked at risk. So lower risk, green light, higher risk, red light. When we look at these short-term bonds, you know, we just don't think it's all that compelling to buy a bond that's due in a year and a half and that yields .4%. The bond's not going to really increase in value. True, you will likely not lose any money, but we've got a longer time horizon than that. So we generally stayed away from bonds in this group 1. But, of course, true low interest-rate risk and low credit risk.

When we then start to look at -- still on the higher credit-quality corporate bonds, we look at longer-term. We like the upside potential. If you look at the -- remember the Apple bond that we talked about before, that bond has been very volatile. But when we were able to invest in a good number of investment-grade bonds earlier on in the year that had traded down to 85 cents on the dollar, 90 cents on the dollar, those bonds have already achieved eight to ten percent returns over a few months for bonds that have no credit risk, or extraordinarily low credit risk. So it's –

Richard Carter: Steve, if I could just jump in here, I mean, that's agreed, but like, you know, isn't it so hard to go into group 2? You've got the red light, which I think is probably fair -- that interest-rate risk, isn't it just so perilous to try and time that?

Steve Shaw: Yeah, it's one of those things -- and we'll talk about it in the next slide, in terms of how volatile treasuries are. But what's important here is that if your time horizon is -- this goes to the benefit of being an investor in individual bonds. We're looking to maximize the return of that bond over the life that we hold. We don't have to report our returns in three months, or at the end of 2021, but we want to have strong returns over the life of the bonds. We have a little bit more flexibility in terms of when we can buy bonds. The other thing is that, as we got -- if you think about the bonds that we were recommending, toward the latter part of last year, as rates were continuing to spike, we generally stayed away from longer-term investment-grade bonds. We needed the market to stabilize a little bit. But then as the yield started to -- as the increase started to ameliorate somewhat, we then started -- if you look at our recommendations, we then started to selectively make recommendations for longer-date investment-grade bonds. Yes, there's certainly risk in that, but we believed it made sense to buy bonds that had fallen materially in value. Because generally speaking, when we look at our returns over the last many years, bonds that we were able to buy at 85 cents on the dollar, that were extraordinarily -- that were of the highest credit quality, those have been winning investments. And so yes, that bond could go down. But if it goes down, it's not the end of the world. We can buy more of that same bond, and have a really nice upside opportunity over time, so long as our time horizon isn't three months or isn't six months, but if it's a little bit longer.

And we'll look at -- you know, as you mentioned, Richard, obviously on these long-term investment-grade bonds, we certainly do have the interest-rate risk, but again, we're not just looking at, okay, what's our return going to be between now and the end of the year? We're looking over a longer term. And we look at fallen angels. So those are bonds -- you know, if you think about it, a fallen angel will still, generally speaking, have the maturity date, so a longer-dated maturity, of an investment-grade bond. But because it's fallen in price, you'll generally speaking have a higher yield, yield to maturity, than a bond that's still rated investment-grade. Since it has fallen into high-yield-land, generally speaking, you're going to have lower interest-rate risk, but you still have, you know, marginally higher or higher credit risk.

And then it brings us to group 4. And this has been somewhat of a challenging area, in that there is so much bond issuance over the last year. And you had scores of companies that were coming to the market to take advantage of -- of strong capital markets, but also, a lot of them, many of them, had to raise money just to kind of get through store shutdowns and the downturn in business. But one of the trends has been that bonds have been issued of so-called high-yield issuers, but the call price is only slightly above where the bond is being issued. And so oftentimes, it can be a really difficult investment call to say, okay, we're going to look at this high-yield bond, but it's priced at par and it's callable in two years at 102. And so it doesn't give you a lot of the upside. Yes, you've got a higher yield, you've got lower interest-rate risk, but it can be difficult. And the reason why this chart is so important is that these bonds in groups 2, 3, and 4 are going to behave differently over time. And so it's why we want to have a variety of bonds in our portfolio. We don't just want to be a one-trick pony. We don't just want to have group 2 bonds, we don't just want to have group 4 bonds, but we want to have a variety, because over time, these bonds are going to rise and fall due to different reasons at different times, and that can create an opportunity for many of these bonds to sell at compelling prices.

Richard Carter: Yeah, that's a great framework, Steve, thank you. And I think, again, I'd like just to press you on the risk component. You know, I think everyone would like these nice green batteries, from the upside potential. But again, maybe you could give us some tangible examples. I mean, again, maybe start with group 2, then, and say "this interest-rate risk is the real risk you've called out." How do you, again, go forth and navigate that, in order to try and deliver the best of the upside?

Steve Shaw: Sure, sure. And what we show here, Richard, on slide 12 -- so if we remember from a few slides ago, we remember how sensitive a bond such as that Apple '45 bond is to treasury yields. And it's more sensitive to the treasury yields than the changing in credit quality of the Apple bond. Because the benchmark yield to maturity made up the bulk of the corporate bonds' yield to maturity. What we show here, Richard, is we show the 30-year treasury yield, all the way back to the beginning part of 2007 up until July 15th. And so you ask a very good question, in terms of -- well, how do you navigate this and how do you deal with the risk? And what we've shown here is -- so this is the 30-year treasury yield. What we've added to this chart are the peaks and the troughs, and the peaks and the troughs of the yield. So we've defined a peak or a trough of any time there is at least a one-percentage-point change in the treasury yield. And what we've then done is we've indicated the peak with an orange bar and then the trough with a green bar. And then we've shown the number of months from the peak to the trough or vice versa and the percentage change. So if we just look at -- let's look at peaks to troughs. And we look at these bottom bars. And so to give one example, when we think of the peak of treasury yields -- and this was -- in the early part of 2007, it was about 5.5%. Then over the next 19 months, it fell all the way down to about 2.5%. And so when we look at the length of time that expires from a peak to a trough, it's anywhere from 19 months on the high end to five months on the low end. And it's a similar story on -- going from the trough to the peak, in that here you have, on the low end, five months to the high end, 28 months. And when you have these changes, you'll typically have an increase of yields that go somewhere -- as it shows here, somewhere from one percentage point up to 2.3%. But the most important thing here is that the treasury market is extraordinarily volatile. People refer to it sometimes as a risk-free market, but it's not risk-free. But if you've got a longer time horizon -- if you've got a time horizon that's, say, three years or five years -- then what can happen is you can be patient. And you can -- let's say that you buy a bond, and -- you know, let's say you ended up buying a bond in the midst of these treasury yields spiking. Now, we recommend that folks invest over time. We don't recommend that you go all in at a specific time, because a treasury market is extraordinarily difficult to predict. Some people try to do it, but, you know, it's a really difficult thing. Well, let's say you bought a bond here -- let's say you bought it in February of this year, but if you bought a small portion, then as yields continue to go up, you could buy more of that bond. And if you have a longer time horizon, you can be patient, as I said before, and -- because we know that based on what's happened over the last 14 years, there's always going to be a peak or there's always going to be a trough. And just because treasury yields tick up, it doesn't mean they're going to tick up forever; they're going to go up for some period of time, but then at some point they'll go back down, and then they'll go back up.

Richard Carter: Well, that's a great chart, Steve, and it is a reminder, isn't it, that it always looks like it is a one-way street, and then all of a sudden (laughter) these treasury yields flip the other way, and have these trending moments as well.

Let's move on to the other side of the chart, then, if I could. You've talked about the more idiosyncratic risk of high-yield, and also, you called out call dates. I think that's one thing that people get nervous about, right, is -- I mean, call features are very prevalent in the corporate bond market. How do you think about that? And, again, going back to the high-yield example, navigating those -- I mean, a lot of research is one answer, but maybe you could just go a bit deeper in that area.

Steve Shaw: Yeah, no, absolutely. So it's important for folks to understand that when we talk about bonds being called -- so, redeemed prior to maturity by the company -- there are different provisions for different types of bonds. And it's really important for investors to understand this and how it all works. So typically, an investment-grade corporate bond is issued with what's called a make-whole call. So if you go on -- you do a bond search on Fidelity, and let's say you look at this Apple bond that we've been talking about, you'll see in big letters, "Call Make Whole." You'll then see down here, under Redemptive Features, where it says "Make Whole Call," it'll say "Yes," okay? So what that means is that the bond is technically callable, but for all practical purposes, the company is not going to call that bond. And the reason for that is when it says "Make Whole," if Apple wanted to call that bond from you prior to maturity, it has to make you whole. And what that means is that it has to pay you the present value of all future interest payments and principal payments. And that's an extraordinary sum of money, and that just does not make financial sense for the bond issuer to do that. So you'll see here, when you click on "View Schedule," there is no call price. There is no call date. Yes, maybe a few months before this bond is due, maybe Apple would call the bond, but generally speaking, this bond is not going to be called. And the reason that's important is because, without a call date, the bond can continue to go up in price without the restriction of the call price. So the yield-to-worst on this bond and the yield-to-maturity on this bond is always generally going to be the same thing, because there's no -- you know, you can't -- it's not as if you buy the bond at 130, then the bond can be called in a year at 105. So that's why this bond can continue to go up in price.

Now, that's very different -- and I refer to this as a bondholder friendly call provision. So if you see "Make Whole Call," that is, generally speaking, a big advantage to own that bond from a bondholder's perspective. But when you then look at high-yield corporate bonds, again, it's a different situation. And these are what I refer to as unfriendly call schedules -- unfriendly to the bond holder, friendly to the bond issuer. So this is a bond that we had previously recommended, M/I Homes -- midsize home builder.

Bond was due in 2025. Now, you'll see that there's no -- it does not say "Call Make Whole" on this. You go down here, under Redemptive Features -- "Make Whole Call," "no." Okay? So you know that this bond is going to be callable based on a specific call schedule. And when you click on this "View Schedule," it shows you a specific schedule. So it shows you, okay, on August 1 of 2020, this bond was callable at 104.219, and then August 1 of this year it was callable at 102.813. So if you think about it, we recommended this bond -- and we'll show in a couple of slides -- at 95, but this bond wasn't going to go up to 110, because no one's going to buy the bond and then have it called from them on August 1 at 102.83 and have a negative return. You're just not going to do that. And so that's what effectively creates a ceiling on this bond. And it happens with lots of high-yield bonds, and it's something that investors, you know, they hear the term "high-yield" and they think, "well, my return's automatically going to be higher," but oftentimes that's not the case, and it can oftentimes be driven by these call schedules.

Now, when we think about navigating call schedules, there are a few different things. So first we want to understand, okay, what price are we buying the bond at, and then where is it callable? So that's fairly elementary. We want to have an idea, okay, if we're buying it at par, you know, is it callable at 102? You know, that doesn't give us a tremendous amount of upside. And that's where we then need to start weighing the gain in yield of a callable bond versus the ceiling that's created by the call price. So if we go back to recommendations we recently made, there were some bonds out there that looked great. And, you know, they were priced maybe around 99, but then they were callable at 102. And the yield on the bond was, say, 4%, and you compared that to, say, an investment-grade bond that had a make-whole call that might have had a yield of 3% -- well, that bond can go higher in price. And so oftentimes you have to weigh, you know, how important is getting that extra 1% yield versus effectively forwarding your upside? We then look -- as we talked about before, monitoring the bonds we recommend is extremely important, so we always know, okay, where's the bond priced, what's the call price? And when's the next call price? Because that's going to impact the upside of the bond, and then it will help us weigh, okay, shall we buy more of this bond or should we sell it? And what other opportunities are out there for potentially higher return?

Richard Carter: That's great, Steve. Okay, so maybe, as we head towards our final section here, we'd just like to ask a little bit more about the selling -- I think that's, again, a unique part of your approach, right? What do you use as some of your selling guidelines and methodology for doing that ahead of maturity or ahead of the call date?

Steve Shaw: Sure. And what we've done here, Richard -- we've shown two case studies. A case study for the M/I Homes bond, and then we're going to show a case study for a long-dated investment-grade bond that was issued by Verizon. And it's important to -- when we think about selling, it's important to also discuss the rationale for buying, and how the investment rationale changes over the life of an investment. And we look at, on the right side here -- so this is this M/I Homes bond, so M/I Homes, five and five-eighths of 25. So this is a bond that we recommended to Bond Savvy subscribers on March 15 of 2019. At the time, it had a price of 95.98 and a yield to maturity of 6.42%. Now, when we look at bonds, we don't just look at the yield to maturity in a vacuum. We do a very stringent analysis of the financials. And one of the things that we look at is what's called the leverage ratio. And so the leverage ratio is just the company's debt divided by its EBITDA or its cash flow. And in this case, the leverage of M/I Homes was 3.2 times, which is actually on par with many investment-grade issuers. Now, this bond was rated below investment-grade, but relative to its financials, the yield was compelling. And so it was a compelling yield, price below par -- the financial performance of M/I Homes had been strong, so we bought the bond at 95.98. And then we held it for a couple of years, and we continued to monitor the financial performance -- and M/I Homes had done extremely well, as have many home builders. And so M/I Homes, the financials just kept knocking the cover off the ball. But as I showed in the previous slide, the bond was callable at 102.8 on August 1 of this year. And the bond just wouldn't budge above -- you know, it went up to 104 at one point, but then it just wasn't budging. And it could have been called at 102.8 on August 1, so that was a case where we said, all right, we're going to sell the bond at 103.15. We did that on January 11 of this year. You'll see the financials were very strong -- leverage had fallen to two times, but there just wasn't any upside remaining in this bond. And when we look at our return, it was 18.2% over the life of the investment compared to the iShares HYG -- that's the iShares high-yield corporate bond fund -- returned 11.66%. So when we look at these individual bonds, we're not just looking to -- you know, many people will be like, well, wow, I got another quarter-percent or another half-percent, but there are times when you can outperform the index fairly significantly.

We then compare that to a different sort of bond -- this is Verizon 3.85s of 2042. This is a bond that, again, when we made our initial set of recommendations -- so this was part of our initial recommendations. The first set, back in September 26 of 2017 -- as I said before, we have an affinity toward bonds of high-quality companies that have fallen below par. This is a bond that at the time was priced at 89.72, had a yield to maturity of about 4.5%. Now, remember, the Apple bonds' credit spread on September 26 of 2017 was .94%. This had a credit spread of 1.82%, so we were being compensated almost a full percentage point more than the Apple bond, and Verizon had really strong financials -- leverage of 2.5 times. Now, as time moved on, we kept monitoring that bond. The bond price moved up pretty significantly -- went up from close to 90 up to 106. This is a case where the credit spread had shrunk down to 1.36%, and at the time, it was only slightly higher than the Apple credit spread, so we didn't think that the credit spread could shrink a lot more. And the other thing is that Verizon pays a big dividend, it is huge capex, and it wasn't going to be paying down debt. So we didn't see that Verizon was going to have a significant change in its credit profile. And for those reasons, we decided to sell the bond. The yield to maturity had fallen, and so in that case, we achieved a return of 27% over two years, which, many would be surprised you could earn that high of a return. And that's more than double the iShares LQD, and that's the iShares corporate bond ETF. It just shows you that if you monitor the bonds and you pay attention in terms of, "okay, where is the bond trading? What upside is remaining?", you can achieve nice capital appreciation and potentially strong returns.

Richard Carter: That's a great story, Steve. I mean, that one particularly, right, I think maybe we'd think Verizon, solid utility, has a very strong market position, and the bonds will just pay their dividend and also their coupon and not expect that kind of return, as you say. So well done here.

So we're almost at time. I want to thank you, firstly, and say that, you know, you've really given us a nice glimpse of all the work you do at Bond Savvy. It's very apparent that you love the topic, and you're dealing with so many variables, right, when you think about, well, what is the bond to recommend, and when should it be judged to be a sell? Could you just summarize, perhaps -- again, we can't go into all these factors, but what other points do you look at when you look at this landscape?

Steve Shaw: Sure. So we talked about some things before in terms of the financials and credit spreads and all those kind of things, but, you know, a few other things we want to keep in mind. You know, we'll obviously look at what the financials are today, but we want to understand, okay, what's the trajectory of this company? Where is it going? Where is the industry going? If it's a higher-risk company, what upcoming bond maturities does it have? Because that's something that can get companies into trouble. If it's got significant maturity that's coming up and it doesn't have the cash flow or doesn't have cash on the balance sheet, we look very carefully at what's called capital allocation. So if a company makes a billion dollars, what is it doing with that billion dollars? Is it just buying back stock and paying dividends, or is it paying down debt? Is it investing in its acquisitions? Is it investing into capex? -- things that can grow the business. While we believe bond ratings can sometimes get it wrong, we do need to know, okay, well, what's the chance for an upgrade or a downgrade? What's the threshold for those upgrades or downgrades? Because those can move the price of a bond fairly significantly. And one last point here is, we want to understand the seniority in the capital structure. Because there are some bond issuers, such as many investment-grade bond issuers -- the only debt is the bonds. And so if it went belly-up, you'd be at the same ranking of the rest of the debt, but one of the things we saw in, say, an issuer such as JCPenney -- the bondholders got wiped out because there was a significant amount of senior bank debt that was senior to them. And so we want to understand that -- especially for the higher-risk bonds, we want to understand, okay, if things go wrong, where are we in terms of seniority? And these are just some of the factors that we think about when we’re making a new recommendation.

Richard Carter: Excellent, Steve. Well, again, time is not on our side, ~~s~~o thank you very much, again, from me and on behalf of everyone listening today. It’s been terrific.

END OF AUDIO FILE

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