Corporate **bonds**

Predictable yields provide retirement appeal

By Ed Avis

Note: This is the last of three stories about bonds and the role they play in an investment portfolio. In this installment, we take a look at corporate bonds.

When you think about a company raising capital, the first idea that likely comes to mind is selling stock, and the second is borrowing money from the bank. But there's a third way many corporations raise cash: by selling bonds, just like governments do.

When a corporation issues bonds, it is basically borrowing money directly from investors rather than from a bank. The corporation pays a set interest rate on the bond and returns the principal when the bond matures (or sooner in some cases, if the bond is "callable").

"Most investors look to high-quality corporate bonds for income and stability," says Michael Stritch, chief investment officer and national head of investments with BMO Wealth Management. "With interest rates above comparable U.S. treasuries and only a marginal increase in repayment risk, high quality corporate bonds play a core role in many portfolios."

When you buy stock in a company, you own part of the company. When you buy a corporate bond, you are just lending money to the company. From an investment standpoint, this means you are trading the potential capital gains that come from investing in stock for the more certain interest payments and repayment of principal that you get with corporate bonds.

This doesn't mean the value of a corporate bond can't change. Bonds are regularly sold on secondary markets, and investors often pay more or less than the original offering price of a bond depending on factors such as inflation, interest rates, and the creditworthiness of the corporation that issued the bond.

"In addition to providing a predictable stream of income, bonds often do well in periods of broader economic weakness and can act as a nice anchor in the event of a stock market drop," Stritch notes. "This is because high-quality corporate bond price changes are closely linked to changes in interest rates, which

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typically fall during periods of market weakness as investors take on a flight-to-quality mentality. As interest rates fall, bond prices rise."

The amount of risk involved and the taxability of the interest are two key differences between government and corporate bonds.

"Financial markets treat government bonds from developed market economies (the U.S., Germany, or Japan, for example) as free from default risk—meaning that the countries which issue these bonds will pay exactly as promised. By contrast, bonds issued by corporations are subject to a company's creditworthiness," explains Guy Lebas, the chief fixed income strategist for financial services firm Janney. "If, for example, ABC Corp. goes out of business, it won't be paying its bonds. In exchange for that default risk, corporate bonds offer more yield than government bonds of similar maturities, with rare exception."

As Lebas notes, corporate bonds typically pay a higher yield than government bonds because of the increased risk. The higher the risk, the higher the yield. An investor who is willing to take on greater risk can earn higher returns by buying bonds of companies with lower creditworthiness; these are called high-yield bonds.

Another important consideration when deciding which bonds to invest in is taxability. The interest income from corporate bonds is taxable, while the income from government bonds, in most cases, is not. That affects the bond's ultimate return, depending on your personal tax rate and whether you are buying the bonds within a tax-deferred retirement account.

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When corporations issue bonds, they negotiate with big banks and institutional investors for the initial issue, and individuals are not part of that game. If you have a good relationship with a broker involved in an initial issue, you can buy newly issued bonds through the broker, but the minimum purchase is generally $25,000, Stritch notes. And, he adds, sometimes brokers mark up the price of bonds that they sell to their clients.

Bond funds are a more common way for individuals to invest in corporate bonds. These offer the advantages of diversification since the funds hold many bonds, and much lower initial investments. But the fees involved reduce the return.

Another investment vehicle for bonds is an exchange-traded fund indexed to bonds. Like a bond mutual fund, ETFs provide diversity. But because of the way bond indexes are weighted, companies with a lot of debt can be more heavily represented, Lebas notes.

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The bottom line for retirees or people nearing retirement: Corporate bonds are an investment option that should be explored.

"Corporate bonds are an appropriate and necessary component of any retirement-based portfolio, because they provide the opportunity for higher returns, relative to Treasuries, with similar levels of volatility," says Constantine Mulligan, a partner at financial services firm Cerity Partners. "When used appropriately, as part of a diversified fixed-income portfolio, investment grade corporate bonds can improve the risk-adjusted returns of the portfolio and facilitate better long-term outcomes." ❱