

Bond Basics

September 2007

What Are Corporate Bonds and What Advantages Do They Offer?

When companies want to expand operations or fund new business ventures, they often turn to the corporate bond market to borrow money from investors. A company seeking to borrow money in the bond market determines how much it would like to borrow and then issues a bond in that amount. Investors that buy corporate bonds are effectively lending money to the company that issued the bonds, according to the terms established in the bond offering.

Size of the Corporate Bond Market

Over the years the corporate bond market has attracted many investors seeking higher yields than those offered by government bonds and other sectors of the global bond market. According to Merrill Lynch data, corporate bonds accounted for about 18% of bonds outstanding in the world in 2006, while the market for government bonds comprised about 53% of the total.¹

Comparing the Major Corporate Bond Markets

As of 8/31/07	U.S.	Euro	U.K.
Outstanding (in billion \$)	2,750	1,424	528
Number of Issues	5,156	1,498	844

Source: Merrill Lynch

Common Characteristics of Corporate Bonds

Unlike equities, ownership of corporate bonds does not signify an ownership interest in the company that has issued the bond. Instead the company pays the creditor that purchased the bond a rate of (taxable) interest over a period of time as well as repayment of principal at the maturity date established at the time of the bond's issue.

While some corporate bonds have redemption or call features that can affect the maturity date, most are loosely categorized into the following maturity ranges:

- Short-term notes (with maturities of up to five years)
- Medium-term notes (with maturities ranging between five and 12 years)
- Long-term bonds (with maturities greater than 12 years)

Corporate bonds share several other vital characteristics, including:

- **Diversification:** Corporates offer the opportunity to invest in a variety of economic sectors. Within the broad spectrum of corporates there is a wide divergence of risk and potential yield. Corporate bonds can improve the diversification to an equity portfolio as well as diversify a fixed income portfolio of government bonds or other fixed income securities.

¹ Source: Merrill Lynch, "Growth trends in the world bond markets", Jan. 26, 2007.

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- **Steady Income:** Corporates have the potential to provide a steady income. Most corporate bonds pay on a fixed semiannual rate schedule. One exception is zero-coupon bonds that do not pay out interest payments but are sold at a deep discount and then redeemed for full face value at maturity. Another exception is floating-rate bonds that have fluctuating interest rates tied to money markets or Treasuries. These tend to have lower yields than fixed-rate securities of a comparable maturity but also less fluctuation in principal value.
- **Attractive Yields:** Corporates tend to provide higher yields than comparable maturity government bonds.
- **Liquidity:** Corporate bonds are often more liquid than other securities and can be sold at any time prior to maturity in a large and active secondary trading market. In the U.S., for example, corporate bond trading averaged about \$15 billion per day in 2006, according to the Securities Industry and Financial Markets Association.
- **Ratings:** Credit agencies such as Moody's Investor Service and Standard & Poor's provide independent analysis of most corporate bond issuers, grading each issuer according to its creditworthiness. Corporate bond issuers with lower-grade credit ratings tend to pay higher interest rates on their corporate bonds (see below for more).

The Corporate Dividing Line: Investment-Grade Versus Speculative-Grade Bonds

Corporate bonds have a wide range of ratings reflecting the fact that the financial health of issuers can vary widely. Corporate bonds fall into two broad credit classifications: investment-grade and speculative-grade (or high yield) bonds. Speculative-grade bonds are issued by companies perceived to have a lower level of credit quality compared to more highly rated, investment-grade, companies. The investment-grade category has four rating grades while the speculative-grade category is comprised of six rating grades. Historically banks were only allowed to invest in bonds in the four highest categories (hence the term 'investment-grade') while the companies with the bottom six ratings were generally considered too risky and speculative (hence the term 'speculative grade') for financial institutions.

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	Moody's	Standard & Poor's
Investment Grade		
Highest quality (Best quality, smallest degree of investment risk)	Aaa	AAA
High quality (Often called high-grade bonds)	Aa	AA
Upper medium grade (Many favorable investment attributes)	A	A
Medium grade (Neither highly protected nor poorly secured)	Baa	BBB
Speculative Grade		
Somewhat speculative (Have speculative elements)	Ba	BB
Speculative (Generally lack characteristics of a desirable investment)	B	B
Highly speculative (Bonds of poor standing)	Caa	CCC
Most speculative (Poor prospects)	Ca	CC
Imminent default (Extremely poor prospects)	C	C
Default	C	D

Historically, speculative-grade bonds were issued by companies that were newer, were in a particularly competitive or volatile sector or had troubling fundamentals. Today, there are also many companies whose businesses are designed to operate with the degree of leverage traditionally associated with speculative-grade companies. While a speculative-grade credit rating indicates a higher default probability, the higher risk of these bonds is often compensated for by higher interest payments or yields. Ratings can be downgraded if the credit quality of the issuer deteriorates or upgraded if fundamentals improve.

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Fallen Angels, Rising Stars and Split Ratings

“Fallen angel” is a term that describes an investment-grade company that has fallen on hard times and has subsequently had its debt downgraded to speculative-grade. “Rising star” refers to a company whose bond rating has been increased by a credit agency due to an improvement in the credit quality of the issuer. Since the credit agencies’ ratings are subjective, there are also times when they do not concur on the same rating—an occurrence known as a “split rating.” Fallen angels, rising stars and split ratings may all present opportunities to add additional yield by assuming greater risk due to the volatility of their ratings situations.

The Basics of Corporate Bond Pricing

The price of a corporate bond is influenced by several factors including: the length of the maturity, the credit rating of the company issuing the bond and the general level of interest rates. The yield of a corporate bond fluctuates to reflect changes in the price of the bond caused by shifts in interest rates and the markets’ perception of the issuer’s credit quality. Corporates typically have more credit risk and higher yields than do government issues of similar maturities. This divergence creates a credit spread between corporates and Treasuries, where the corporate bond investor is “buying” extra yield by taking on greater risk. The credit spread is a determining factor affecting the price of the bond and can be graphically plotted and measured as the difference between the yield of a corporate and government bond at each point of maturity along the yield curve.

Conclusion: Corporate Bonds Offer A Myriad of Attractive Potential Benefits

Corporates can broaden a risk profile and diversify a portfolio of equities and/or government bonds depending on the economic environment, the credit rating of the bond issuer and the level of risk tolerance sought. In addition to diversification they offer the potential for steady income and attractive yields, liquidity and a ratings system that potentially guides investment opportunities.

Past performance is no guarantee of future results

Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest. Shares of a portfolio that invest in them are not guaranteed. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Diversification does not ensure against loss. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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