CORPORATE BONDS

Evaluating the investment grade corporate bond market

Alex Claringbull explains how the cheapest valuations since the 1930s are making corporate bonds extremely attractive to professional investors, and why ETFs provide an effective way to access the asset class

Why has there been such a high level of interest in high grade corporate bonds over the last few months?

In a recent survey Merrill Lynch asked institutional investors about their outlook for corporate bond returns. Over 70 per cent of all respondents believed that on a relative basis vs government paper, corporates are undervalued.

They also think that corporate spreads will tighten over 2009, and that especially investment grade corporate debt will provide the best risk-adjusted returns of any fixed income asset classover the next 12 months, as illustrated in Figure 1.

Investors are expressing this view at a time when the world economy is arguably facing the worst global recession since the Great Depression. Consumers are reacting to the economic environment by reducing their discretionary spending and companies are facing a significant slowdown in earnings and increasing balance sheet leverage.

More of them will fail and that in turn will lead to rising defaults on corporate debt and diminishing returns. So this has to beg the question, why are professional investors still so keen to own corporate bonds?

The answer is readily found when looking at a historical chart showing corporate bond spreads of BBB-rated investment grade companies over US Treasuries. At no point since the Great Depression has corporate debt yielded quite as much when compared to government bonds.

"AT NO POINT SINCE THE GREAT DEPRESSION HAS CORPORATE DEBT YIELDED QUITE AS MUCH WHEN COMPARED TO GOVERNMENT BONDS"

Figure 2 shows the yield spread of BBB US corporate bonds over treasuries. Judging from a spread perspective it seems that investment grade debt is offering us the opportunity of a lifetime.

But cheap valuations might not be enough to warrant an investment in the midst of a global financial crisis that is increasingly affecting the real economy.

UNDER THE BONNET

Valuations have been considered cheap before. To be precise in October 2008 just before spreads widened even further. Often investors look under the bonnet of the headline figure to determine which sectors are driving the actual returns or the current spread levels.

Figure 3 plots the credit spread for financial and non-financial corporate bonds. As can be seen the credit spread is higher for financial assets which is reflective of the increased current risk associated with banks compared to the non-financial sector.

These relationships change over time and the analysis of the changing levels often give signals to investors about investing into investment grade corporate bonds.

However, in order to assess the attractiveness of spreads it is necessary to derive some measure of fundamental value that they can be compared against. In theory spreads should compensate the investor for future defaults plus a

risk premium for the relative illiquidity of the asset class.

If both are large enough the investment can be deemed to have a good risk-return relationship. To perform this analysis it may be appropriate to look at the so-called Rock-Bottom Spread. This spread uses future estimates of bond defaults which are derived from historical data and specifies the minimum spread that the investor should receive to compensate for the defaults he expects.

The difference in between the Rock-Bottom spread and the observed spread is the excess credit risk premium that is received above the compensation for expected defaults.

RISK PREMIUMS

Figure 4 shows this risk premium over the last 10 years to the end of December 2008. It highlights that on average, until the beginning of the financial crisis, the credit risk premiumof BBB+ rated US corporate bonds has been approximately 50 basis points.

Since the financial crisis began however, credit risk premia have been rising and are offering a handsome reward for anyone willing to hold corporate paper.

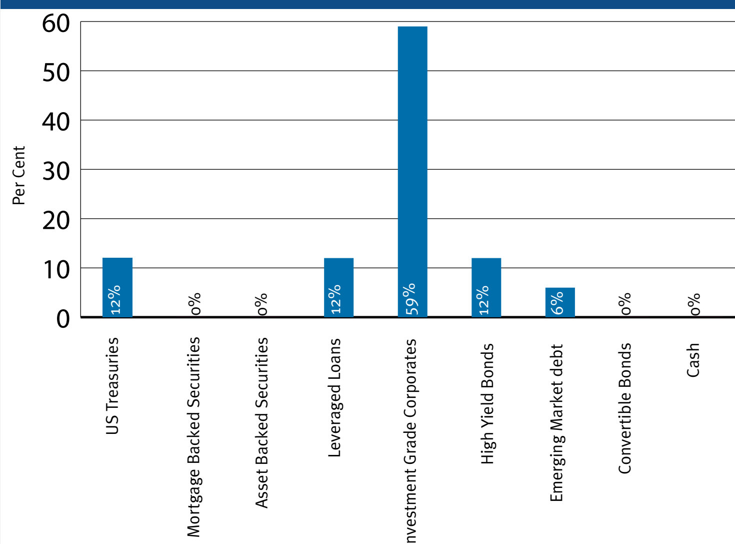
Taking a slightly different perspective, over a five-year horizon, current investment grade credit spreads will compensate the investor for up to 20 per cent of defaults in their portfolio.

Since 1970 the worst five-year period has produced 2.4 per cent of corporate defaults, and the average five-year period recorded only 0.8 per cent. This means the current spread levels compensate the investor for over eight times historical defaults.

Arguably it is this perceived value that is driving investor sentiment.

Finally, by looking at the daily trading volumes of the iShares iBoxx $ Investment Grade Corporate Bond Fund (US) it is possible to see that actual trading

Figure 1: Fixed income sector 12-months risk-adjusted return

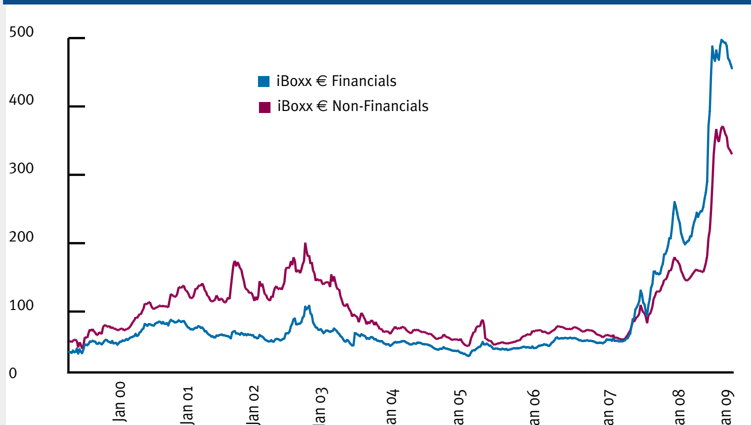


Source: Merrill Lynch Credit Market Survey, 16 December 2009

Figure 2: US corporate BBB spreads to treasuries (%)

Source: Citigroup, Federal Reserve

Figure 3: Financial and non-financial investment grade corporate spreads in basis points



Source: iBoxx

is reflective of the incremental evidence pointing to increased demand for the asset class, therefore investors are increasingly using ETFs to express their view in investment grade corporate bonds.

"ETFS REPRESENT A HIGHLY-ATTRACTIVE MEANS OF CAPTURING THE PERFORMANCE OF CORPORATE BONDS"

For investors concerned about the lack of corporate bond liquidity in an individual bond portfolio an ETF offers an accessible, cost effective and liquid alternative.

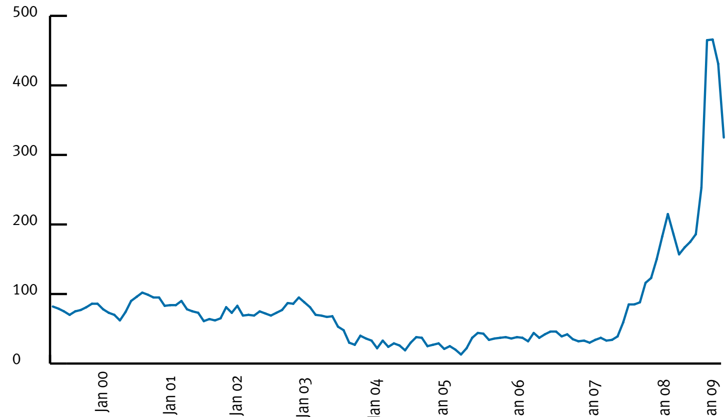
There are currently three iShares ETFs in Europe which arelinked to corporate bond returns:

- iShares $ Corporate Bond
- iShares € Corporate Bond
- iShares £ Corporate Bond

These iShares ETFs provide investors with a cost-efficient and highly flexible means of acquiring instant exposure to a strictly-defined basket of corporate bonds.

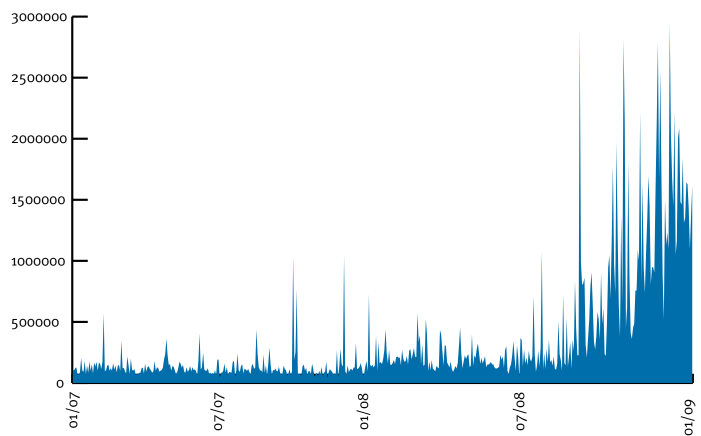
Offering high levels of liquidity and transparency, these ETFs represent a highly-attractive means of capturing the performance of corporate bonds, as demonstrated by their rapidly-growing trading volumes as professional investors increasingly make use of these powerful portfolio management tools.

Figure 4: BBB+ US credit risk premium (bps)



Source: Barclays Global Investors

Figure 5: Daily trading volumes for iShares iBoxx $



Source: Barclays Global Investors

ETFs can be held individually or as part of a more sophisticated strategy using multiple fixed-income ETFs.

iShares, the world's leading provider of ETFs, now offers 59 fixed income ETFs as part of its global range of funds over 360 funds covering fixed income, equities and alternative investments.

Alex Claringbull is senior fixed income portfolio manager for iShares

iShares is the world's number one exchange Traded Fund (ETF) provider, managed by Barclays Global Investors, one of the world's largest asset managers and a leading global provider of investment management products and services with more than 3,000 institutional clients and approximately $1.5 trillion of assets under management as of December 31, 2008. Investors can use iShares's ETFs to gain a diversified exposure into the performance of key benchmarks and asset classes. iShares's extensive ETF offering allows investors to instantly build tailor-made investment portfolios, adjust their risk profile and benefit from new market trends in full transparency and at very competitive rates.
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