Why Not Invest in BBB- and lower rated bonds?

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We received a question from one of our newsletter readers asking why we only recommend buying highly-rated bonds, when lower-rated bonds have a higher return: hence the financial industry's preferred name of 'high yield' rather than the original moniker of 'junk.' First, a definition: Triple-B minus (Moody's Baa- and S&P, Fitch and Kroll BBB-) is one level above junk bonds. If bonds are downgraded to junk bonds, the nature of the holding changes dramatically for the worse.

For starters, mutual funds and ETFs may hold designated amounts of high-yield (junk) debt. If they exceed the designated percentage of the debt they are allowed to hold, they must sell some to comply with their prospectus. Who are the buyers of that debt? It used to be that the banks made a market, but due to new security regulations, they no longer do. As a result, that debt must be sold to other funds or broker-dealers, who may also have their own blocks of bonds they want to sell.

The US junk bond market has doubled in amount in the last 10 years to $1.2 trillion. The leveraged loan market has doubled as well to nearly $1.3 trillion. Triple-B minus bonds, the lowest investment grade, have jumped to nearly $2 trillion, representing almost 40% of the US nonfinancial corporate bond market. All of this growth in lower- rated bonds has made the bond market much more volatile and riskier.

Why Consider the Ratings?

Ratings are not perfect, but they are the best guide we have to consider risk at a glance. We do not recommend buying bonds rated lower than double-A (Aa for Moody's and AA for S&P, Fitch and Kroll) because the risks keep piling up, particularly for long-term bonds. It is possible to do a deep dive and find low rated credits that have some resiliency, but this is time

consuming and difficult to do. Because lower-rated issuers have fewer resources, they may be more subject to downgrades.

The Triple B- rated bonds need a great deal of monitoring for their entire term. If you were to buy lower rated bonds, the strategy of buy and hold becomes risky. We have bought more than $5 billion of bonds for clients over the years with no loss of interest or principal. As a result of our very low fees, we unfortunate cannot afford a staff to constantly evaluate and trade bonds.

Double-A rated munis today are not the same as a double-A rated munis before 2010. Moody's, S&P and Fitch rating agencies have all recalibrated their ratings so that taxable municipal bonds would be directly comparable to corporate bonds. Instead of lowering the ratings on corporate bonds, they raised the ratings on munis, diluting to some extent the value of the muni ratings, both taxable and tax-exempt.

If you are considering very risky bonds, first calculate how much more in interest you need to justify purchasing a bond for which you may get back somewhere between 25 and 75 percent on the dollar.

China Evergrande Group

For example, if you were investor in high-yield international bonds, what is your next move after you read that the price of the largest Chinese property development Company, Evergrande's dollar bonds have fallen from a price of about 90 on January, 1 2021 to about 30 on September 20, 2021. [i] Mutual funds such as Blackrock, Pacific Investment Management Co and Ashmore Group loaded up on Chinese bonds due to their higher yield despite the appearance of a property bubble.[ii]

Evergrande bonds were sold on the basis that the Chinese property market was favored by the Chinese government, and the $89 billion in debt as of June 2021 made them a lower risk than their rating might imply. Remember too big to fail?

Changes in the political climate in China in the early part of 2021, resulting in a government demand for lower corporate leverage and debt limits, pummeled many debt-bloated Chinese bonds. Chinese companies such as Evergrande, Fantasia Holdings Group and Guangzhou R&F Properties and others, have seen the value of even their short-term bonds plummet. As you can see, the short maturity is not a protection for the investor.

Liquidity

As we all know, we are living in very volatile times. In such times liquidity is very important. In an SEC filing, Nuveen, a very large fund company, announced in September 2021 the closing of its high- yield and California high-yield bond funds because there was such demand that the yield compression among the ratings is making purchasing the bonds too expensive. That means that you are not sufficiently compensated by higher yields for the bonds with lower ratings.

Buying lower rated bonds results in reduced liquidity. In volatile times you want/need liquidity to possibly sell your bonds. We believe that the stock and financial markets are at significant current risk. For example, with the Fed contemplating reducing its fixed income purchasing, the markets could get dicey rather quickly.

The extra yield of 25 to 50 basis points[iii] on lower rated bonds does not make up for the disadvantages set forth above.

Current Return vs Yield-to-Call and Yield-to-Maturity

Most investments are based on the notion of current return. For example, when you purchase real estate or funds of any kind, the market makers quote you a current return. The current return calculation is quite simply the yearly return divided by the price that you paid. The current return on a bond is calculate by dividing the coupon by the price that you pay. Thus, for example if you pay 120 for a bond that has a 4% coupon, your current return is 3.33% (4/120). The current return on a bond with a 5% coupon for which you paid 130, has a current return of 3.84% (5/130). If you are buying tax-free muni bonds for their cash flow, these bonds have a return that you might find of interest. Investors in muni bonds also look at yield-to-maturity and yield-to-call calculations before buying a bond.

In order to get a higher current return, you might consider buying long-term bonds (25-30 years) to get some extra yield. We are able to buy long-term bonds since all current clients have a bond ladder with many bonds callable or due within 5 years. Our strategy is to buy and hold. In today’s market, this strategy creates a barbell type portfolio, with heavier weighting on the shorter and longer ends of the market. Many bonds maturing in the intermediate range may be called away, as issuers replace them with lower yielding bonds.

Conclusion

Reducing the quality of your new bond purchases in order to gain some additional yield, will not change your financial position in a significant way. If you reinvest your cash now and if interest rates rise in the future, you will have the cash flow to dollar cost average and reinvest at higher rates when your bonds are called or come due. You will earn interest on your cash while you wait.

Also consider that interest rates may decline in the future. We now know that negative rates are a possibility we cannot ignore.

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[i] Frances Yoon. "Riskier Chinese Property Bonds Sink." *The Wall Street Journal.* September 13, 2021, p. B1.
[ii] Matt Wirtz. "Chinese Evergrande Fallout Hits Western Bond Funds, *The Wall Street Journal.* September 20, 2021.
[iii] Investopedia.com/terms. "**Basis points** (**BPS**) refers to a common unit of measure for interest rates and other percentages in finance. One **basis point** is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument."