Schwab Center for Financial Research

Bet on Credit Instead of Maturity

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Own your tomorrow

Many investors are committed to allocating a portion of their portfolio to bonds. Whether it is because they are seeking income or they are uncomfortable with stock market risk, bonds are a major part of their portfolios, and they want to know which segment of this diverse market is most attractive. Kathy A. Jones and Collin Martin share their thoughts.

Kathy A. Jones
Vice President, Fixed Income Strategist, Schwab Center for Financial Research

Kathy A. Jones is responsible for credit market and interest rate analysis, as well as fixed income education for investors at Schwab. Jones has studied global credit markets extensively throughout her career as a fixed income investment strategist, working with both institutional and retail clients.

Collin Martin
Senior Research Analyst, Fixed Income, Schwab Center for Financial Research

Collin Martin is responsible for providing analysis and investor education in fixed income. Prior to joining Schwab in 2012, Martin was a fixed income strategist with Morgan Stanley Smith Barney, where he published fixed income model portfolios for individual investors. He also contributed to monthly fixed income strategy publications, focusing on international debt markets.

Executive Summary

- The declining trend in interest rates over the past 30 years has been good for fixed income investors. Long-term Treasury bonds have been a major beneficiary of this trend. With bond yields at their current low levels, there is little room for yields to fall further. This means there is less potential for price appreciation, because bond prices and yields move in opposite directions.
- Even if interest rates stay low for a while longer, investors shouldn't ignore the risks that rising interest rates could pose to their bond portfolios.
- As a result, we advise that investors stick with bonds that have short and intermediate maturities and consider investing in highly rated corporate bonds.
- Companies have strong balance sheets and hoards of cash, meaning corporate credit is strong and the incremental yield of highly rated corporate bonds is worth it in a low-yield environment where every basis point helps.

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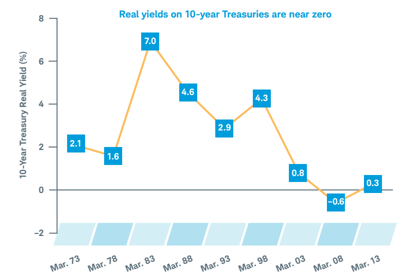
the reward for taking risks is better in investment-grade corporate bonds than in long-maturity Treasuries. We think investors should shy away from duration risk because interest rates are so low, and look to corporate bonds that have higher coupons and short to intermediate maturities.

What if I am a buy-and-hold investor? I thought rising rates affect only those who sell their securities prior to maturity.

That's true. Barring default, bondholders would receive their principal back when the bond matures, and price fluctuations would be unrealized. For buy-and-hold investors, the yield to maturity of a bond is what matters.

But with yields so low, we don't see the attraction of long-term Treasuries—aside from the diversification they may offer your portfolio. Central banks in many countries are holding interest rates at or below the rate of inflation in an effort to ease banking sector problems and spur economic growth. The Federal Reserve System, in setting its short-term interest rate target near zero, is holding Treasury bond yields at levels below inflation, eroding the principal and interest value. For long-term bond investors in Treasury bonds, low nominal or even negative real yields create a dilemma. Real yields adjust for the effects of inflation. Treasuries continue to be perceived as risk-free assets from a credit perspective, but the prospects for returns are poor, especially after taking inflation into account.

Look to corporate bonds that have higher coupons and short to intermediate maturities.



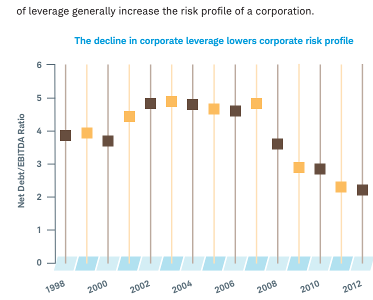
Source: Bloomberg. Monthly data as of March 29, 2013. Real yield is represented by the U.S. Generic Govt 10 Year Yield (USGG10YR) minus year-over-year change in the U.S. Consumer Price Index for All Urban Consumers.

So the risk to longer bonds really hits when interest rates rise. Do you think a rise is imminent?

It could be. The Fed has recently indicated that it may be reducing the amount of bonds it buys under its Quantitative Easing (QE) program, which could be a first step toward allowing interest rates to move higher. We don't, however, see a return to the level of interest rates that prevailed before the financial crisis in 2007 in the near future. A more likely scenario, in our view, is a gradual movement higher over the next few years.

That doesn't mean, however, that investors can ignore the potential impact that a turn in the decades-long trend in rates would have on bondholders. Starting from the current level of very low yields, even a relatively small rise in rates could cause a steep decline in bond prices, particularly for long-term bonds and bond funds.

Another encouraging aspect of corporate balance sheets is the declining amount of leverage, as illustrated in the chart below. Leverage is a measure of a firm's debt relative to its earnings. It has declined, on average, since the onset of the financial crisis in 2007–2008. All else being equal, higher amounts of leverage generally increase the risk profile of a corporation.



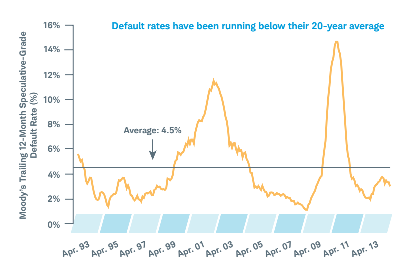
Source: Bloomberg, as of December 31, 2012. Reported data are representative of the S&P 500® Index. Corporate leverage is a measure of a firm's debt relative to its earnings. We define leverage as net debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization). EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and it can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

But even with strong fundamentals, corporate bonds can still default. Do you think default rates will pick up?

It is difficult to forecast defaults, but we think the default rate will remain low. The strong corporate fundamentals we just discussed are supportive of low default rates, as is the availability of credit in the capital markets.

The availability of credit has allowed corporations to extend their refinancing schedules by issuing low-coupon, longer-term bonds to retire their higher-coupon short-term maturities. This is beneficial to the issuer, as it reduces interest expense and short-term liabilities. Reducing debt to short-term liabilities and having access to liquidity can improve the creditworthiness of bond issuers, potentially reducing the risk of default.

This chart shows that default rates have been running below their 20-year average, a trend we believe will continue at least through the end of this year.



Monthly Default Report—March 2013," April 2013. Trailing 12-month speculative-grade default rate. The cumulative default rate calculation methodology used by Moody's is a discrete-time approximation of the nonparametric continuous-time hazard rate approach. A pool of issuers, called a cohort, is formed on the basis of the rating held on a given calendar date (or set of dates), and the default/survival status of the members of the cohort is tracked over some stated time horizon, which in this instance is 12 months. Default rates include only bonds rated by Moody's.