

# Rethinking Bond Investing

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## These 15 companies have one thing in common...

- Boeing
- Ford
- Disney
- Macy's
- TJX
- Marriott
- Delta Airlines
- Occidental Petroleum
- Royal Dutch Shell
- Anheuser-Busch
- Freeport-McMoRan
- GM
- Schlumberger
- Las Vegas Sands
- Raytheon

**...they have all recently suspended or reduced  
stock dividend payments...**



Dividend stock investors

Corporate CFO

## ...and, combined with pausing share buybacks, the savings – and negative shareholder impact – is significant

### Dividend & Buyback Summary (\$ in millions)\*

Company	Fiscal 2019			Since Q1 2020			12/31/19 Ratings
	Revenue	Dividends	Buybacks	Suspended Dividends	Cut Dividends	Paused Buybacks	
Royal Dutch Shell	\$344,877	\$15,198	\$10,188	--	66% cut	√	Aa2 / AA-
Boeing	\$76,559	\$4,630	\$2,651	√	--	√	A3 / A-
Disney	\$69,570	\$2,895	0	√	--	√	A2 / A
Anheuser Busch InBev	\$52,329	\$5,015	0	--	50% cut	--	Baa1 / A-

# Attributes of Individual Corporate Bonds



Contractual interest payments and return of principal



Financial covenants that protect investors



Senior to common and preferred stock



Wide variety of risk/reward opportunities

# Corporate Bond Returns Will Surprise You

	Date		Total Return	
	Bought	Sold/Valued	Our Bond	iShares*
<b>Verizon 3.85% '42</b>	89.72	106.43	<b>27.01%</b>	<b>12.53%</b>
<b>Bed Bath 3.749% '24</b>	85.85	98.28	<b>20.73%</b>	<b>17.34%</b>
<b>Tiffany 4.90% '44</b>	103.01	128.00	<b>26.08%</b>	<b>2.03%</b>
<b>Albertsons 7.45% '29</b>	78.50	107.50	<b>63.47%</b>	<b>6.26%</b>

\*iShares returns are for the comparable iShares bond ETF: LQD for Verizon, Tiffany, and Bed Bath, and HYG for Albertsons. Click the Returns tab on the BondSavvy website to see returns data for all previous BondSavvy investment recommendations.

# TODAY'S AGENDA

- Why bond investing needs a new approach
- Individual corporate bonds vs. other investments
- Corporate bonds 101
- Shortcomings of bond ratings
- What makes corporate bond prices move
- Why bond ladders are broken
- Active bond investing: how it works and why it's better

## Let's Rethink the Old Way of Doing Things

- Best to 'leave it to the fund experts' – bond investing is too hard
- Investors can't beat the index
- Always hold bonds to maturity
- Focus on a bond's yield rather than capital appreciation opportunities
- Bonds only return 2-4%
- If 'interest rates' rise, bond prices ALWAYS fall
- A credit rating and a yield is all you need to evaluate a bond



# Three Things You Need To Know Before Making an Investment

- The price
- How investment's 'value' compares to similar investments
- The ongoing costs of the investment

## With Bond Funds, You Know “None of the Above”



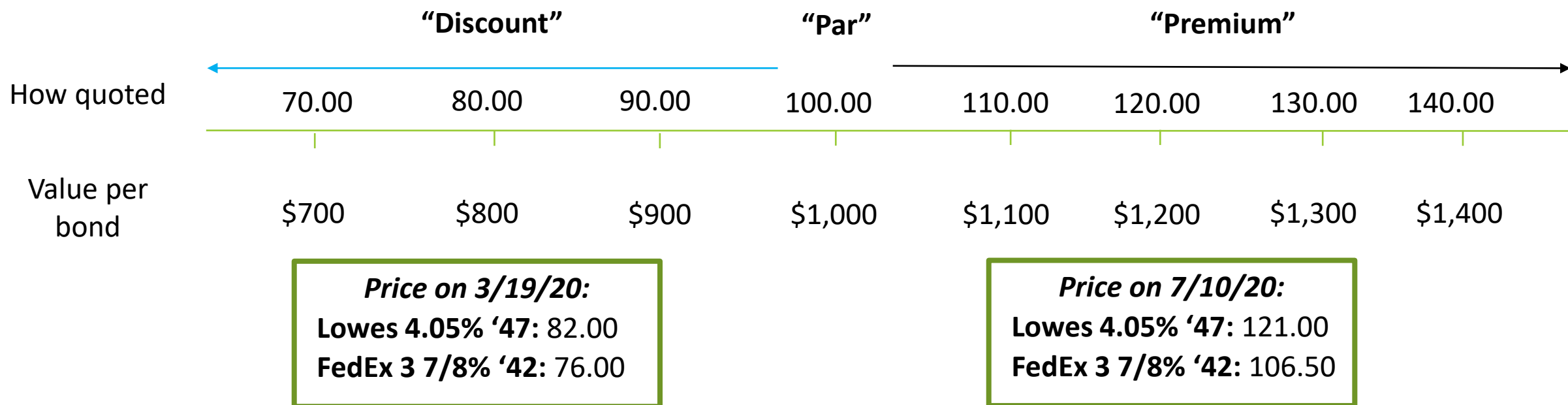
- Impossible to compare value of fund vs. fund
  - Thousands of securities owned and always changing
  - Funds priced to NAV not par value
  - Few ‘pure-play’ bond funds make it difficult to compare relative performance
- High fund turnover drives high, undisclosed fees and hurts performance

## Bond Funds: Impossible-to-assess prices and high turnover

















Bond Fund	Net Assets \$BB*	Recent Price	Turnover*
Vanguard Total Bond Market Index Fund (VBTLX)	\$229.3	11.09	54%
iShares AGG	\$58.0	112.62	146%
PIMCO Total Return	\$65.4	10.44	723%
MetWest Total Return	\$75.6	10.97	268%

## Advantage #1: Bonds vs. Bond Funds

Individual corporate bonds are all quoted as a percentage of their face value, enabling investors to begin assessing a bond's relative value



# Individual Corporate Bonds vs. the Competition

	Individual Corporate Bonds	Bond Funds	Muni Bonds	Stocks
High Potential Returns				
Transparent				
Security of Principal				
Security of Income				

# Benefits of Owning the Bond Rather Than the Stock

## May 2, 2018-October 7, 2019 Performance: Bed Bath & Beyond

### Bed Bath Stock (1)



### Bed Bath '24 Bonds (2)



(1) Source: macrotrends.net

(2) Source: FINRA TRACE market data

# Corporate Bonds 101

# Kroger 3.875% 10/15/46

**CUSIP: 501044DF5**

<b>Issue date</b>	September 26, 2016
<b>Annual coupon for each bond</b>	\$38.75
<b>April 15 coupon payment</b>	\$19.37
<b>October 15 coupon payment</b>	\$19.38
<b>Annual interest for 10 bonds</b>	\$387.50
<b>Maturity date</b>	October 15, 2046
<b>Term</b>	30 years
<b>Principal repaid at maturity per bond</b>	\$1,000



## How Bonds Are Quoted & What You Pay

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Kroger '46 Bid / Offer Quote

**83.00 / 84.00**

**How bonds are quoted:**

- Percentage of face value
- Face value of one bond is \$1,000
- Online quotes before 0.1 pts markup/down

Sell 1 Bond for:

**\$830.00**

Buy 1 Bond for:

**\$840.00**

***Plus Interest Accrued  
Since Last Coupon***

## Current Yield vs. Yield to Maturity – Kroger 3 7/8% 10/15/46

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	<u>Quoted Price</u>	<u>Annual Coupon</u>	<u>Value per Bond</u>	<u>Current Yield</u>	<u>Yield to Maturity</u>
<i>Discount</i>	<b>84.00</b>	\$38.75	\$840.00	4.61%	4.98%
<i>Par</i>	<b>100.00</b>	\$38.75	\$1,000.00	3.875%	3.875%
<i>Premium</i>	<b>105.00</b>	\$38.75	\$1,050.00	3.69%	3.58%

# Technology Has Put Individual Investors on a More Level Playing Field with Institutional Investors

25 Years Ago



Today



*Investing online enables investors to see broad inventory at competitive prices*

# Most Corporate Bonds Trade in a Liquid and Competitive Market

Bids			Offers		
Yield	Quantity(Min)	Price	Price	Quantity(Min)	Yield
<b>4.00%</b>	<b>99(10)</b>	<b>99.970</b>	<b>100.094</b>	<b>43(2)</b>	<b>3.99%</b>
4.015	11(2)	99.779	100.103	273(5)	3.993
4.015	110(5)	99.779	100.108	105(5)	3.992
4.027	85(2)	99.601	100.261	109(5)	3.982
4.027	400(10)	99.598	100.310	165(10)	3.979
4.034	150(2)	99.500	100.378	89(5)	3.974
4.034	100(10)	99.500	100.407	99(2)	3.972
4.040	45(10)	99.415	100.440	100(10)	3.970
4.047	250(5)	99.306	100.450	200(2)	3.969
4.053	2000(250)	99.219	100.549	500(10)	3.962
4.072	500(250)	98.946	100.684	1000(2)	3.953
4.081	300(2)	98.815	100.703	2000(250)	3.952
			101.500	10(2)	3.898
			101.659	325(2)	3.887

## eBay 4.00% 7/15/42 Example\*

- 12 quotes on bid side
- 14 on offer side
- 0.12-point 'dollar-price' spread
- 0.01 percentage point spread on yield basis
- 2- to 10-bond minimum quantities

**Bond markets did become less liquid during March / April due to COVID-19**



\* Depth of book shown on Fidelity on January 22, 2020.

# Credit Ratings Impact Bond Prices but Have Many Shortcomings

	Moody's	S&P
Investment Grade	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
Non-Investment Grade or "High Yield"	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B1	B+
	B2	B
	B3	B-
	Caa1	CCC+
	Caa2	CCC
	Caa3	CCC-



**Bond ratings impact how bonds trade:**

Investment-grade bonds are sensitive to changes in Treasury yields

Upgrades and downgrades can impact corporate bond prices

**But....they have many shortcomings:**

Can often go years without changing

Don't speak to the value of a bond

"Fuzzy metrics" often weighted more heavily than traditional credit ratios

# Good BBB vs. Bad BBB

Many market gurus have warned about lurking trouble in BBB-rated corporate bonds, but it's important to understand that not all BBB bonds are created equal

- Kroger and Anheuser-Busch InBev (AB InBev) have very similar ratings; however, Kroger has much stronger financials
- Kroger represents what an investment-grade issuer should be: a very strong business with leverage less than 3x
- AB InBev has 5.1x leverage\* and weak performance in wake of COVID-19
- Investors doing their homework can find opportunities where a bond issuer's credit risk is not aligned with its bond rating

## Kroger vs. AB InBev Financials \*

<i>\$ in millions</i>	<b>Kroger</b>	<b>Anheuser-Busch InBev</b>
June 15 '20 Rating	Baa1 / BBB	Baa1 / BBB+
Cash	\$2,726	\$7,169
Total Debt	<b>\$12,603</b>	<b>\$100,949</b>
Revenue (Last 12 Months)	\$126,584	\$51,108
EBITDA (Last 12 Months)	<b>\$6,028</b>	<b>\$19,903</b>
Leverage Ratio	<b>2.1x</b>	<b>5.1x</b>
<b>Q1 '20 Growth</b>		
Revenue	11.5%	-10.0%
EBITDA	25.2%	-17.7%
<b>Credit Spread (June 26, 2020)**</b>		
2029 Bond	1.05%	1.49%
2046 Bond	1.78%	2.23%

\* AB InBev balance sheet data are as of 12/31/19 while its income statement figures are through 3/31/20. Kroger's financials are for the period ending 5/23/20

\*\* Credit spread data shown on Fidelity.com.

# Why Kroger and AB InBev Have Similar Ratings

- Based on industry, Moody's and S&P weigh different factors to determine a corporate bond's rating
- Since "Leverage and Coverage" only comprise 30% of AB InBev's rating, the other factors inflate its rating, which results, in our view, an undeserving Baa1 Moody's rating for the company

## Moody's Weightings: Retail Industry

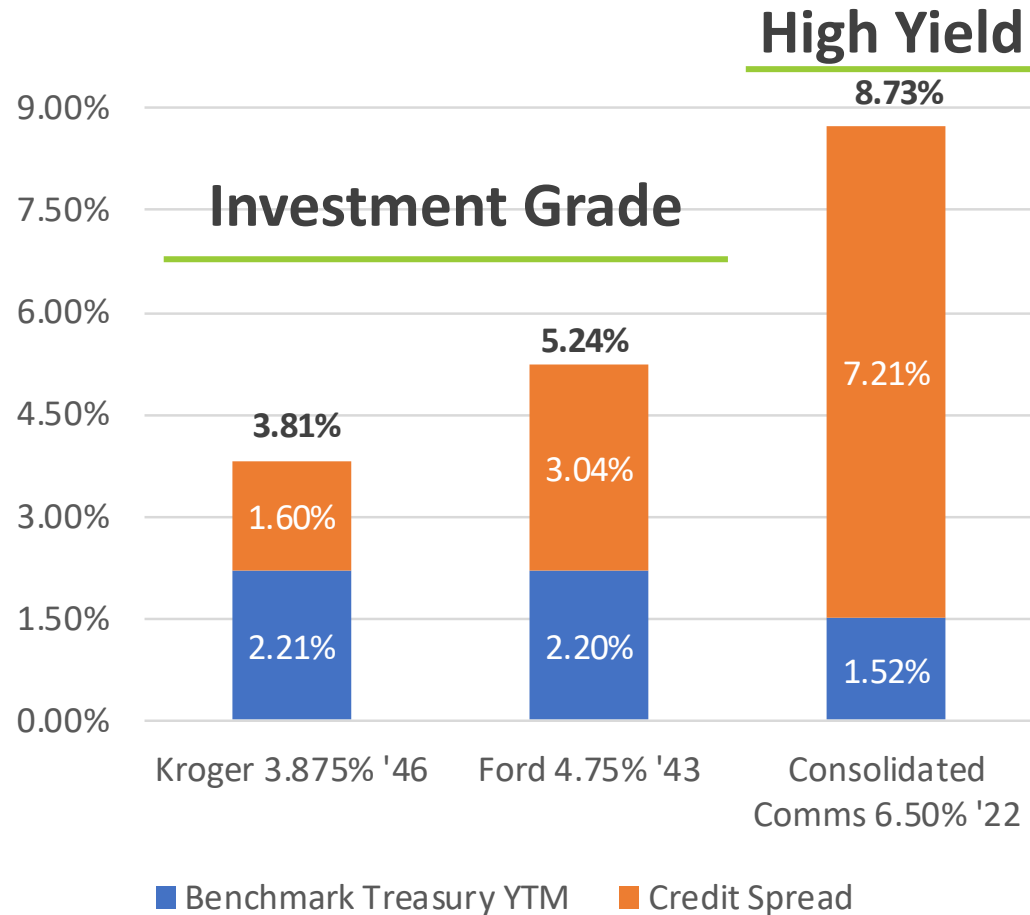
Factor	Factor Weighting	Sub-Factor	Sub-Factor Weighting
Scale	10%	Revenue	10%
Business Profile	30%	Stability of Product	10%
		Execution and Competitive Position	20%
Leverage and Coverage	45%	EBIT / Interest Expense	15%
		Retained Cash Flow / Net Debt	15%
		Debt/EBITDA	15%
Financial Policy	15%	Financial Policy	15%
<b>Total</b>	<b>100%</b>	<b>Total</b>	<b>100%</b>

## Moody's Weightings: Alcoholic Beverage Industry

Factor	Factor Weighting	Sub-factor	Sub-factor Weighting
Scale	15%	Revenue (USD Billion)	15%
Business Profile	32.5%	Diversification and Exposure to Riskier Markets	10%
		Category / Brand Strength and Diversification	7.5%
		Global Industry Position	7.5%
		Innovation, Distribution and Infrastructure	7.5%
Profitability	7.5%	EBITA Margin	7.5%
Leverage and Coverage	30%	RCF / Net Debt	10%
		Debt / EBITDA	12.5%
		EBIT / Interest Expense	7.5%
Financial Policy	15%	--*	15%
<b>Total</b>	<b>100%</b>		<b>100%</b>

\*This factor has no sub-factors.  
Source: Moody's Investors Service

# How Treasury Yields & Credit Spreads Impact Bond Prices



**Benchmark  
Treasury YTM**

**+**

**Credit Spread**

**=**

**Corporate  
Bond's YTM**



# You can now read the WSJ bond tables 😊

## Corporate Debt

Price moves by a company's debt in the credit markets sometimes mirror and sometimes anti that same company's share price.

### Investment-grade spreads that tightened the most...

Issuer	Symbol	Coupon(%)	Maturity	Current	Spread*, in basis points		Last week
					One-day change		
HSBC Holdings	HSBC	6.250	March 23, '49	353	-18		350
Goldman Sachs	GS	5.300	July 27, '49	304	-13		307
Shell International Finance BV*	RDSALN	1.750	Sept. 12, '21	28	-11		41
Suncor Energy	SUCN	6.500	June 15, '38	155	-9		n.a.
Discovery Communications	DISCA	4.125	May 15, '29	169	-8		173
Branch Banking And Trust	BBT	2.625	Jan. 15, '22	53	-6		n.a.
Banco Bilbao Vizcaya Argentaria S.A.	BBVASM	6.500	March 5, '49	428	-6		n.a.
Las Vegas Sands	LVS	3.900	Aug. 8, '29	198	-6		201

### ...And spreads that widened the most

EQT	EQT	3.900	Oct. 1, '27	440	26		386
Newell Brands	NWL	3.850	April 1, '23	154	16		n.a.
General Motors Financial	GM	3.700	May 9, '23	153	12		143
Bank of Montreal	BMO	3.300	Feb. 5, '24	76	10		73
Discover Financial Services	DFS	5.200	April 27, '22	90	10		n.a.
ERP Operating	EQR	2.500	Feb. 15, '30	98	10		95
AbbVie	ABBV	3.200	May 14, '26	127	8		136
Baxter International	BAX	3.500	Aug. 15, '46	145	8		n.a.

- Numbers presented in 'basis points' or 'bps'
- 100 basis points = 1.00%
- 353 basis points = 3.53%



# You can now read the WSJ bond tables 😊

## High-yield issues with the biggest price increases...

Issuer	Symbol	Coupon (%)	Maturity	Bond Price as % of face value		
				Current	One-day change	Last week
Teva Pharmaceutical Finance Netherlands lii	<b>TEVA</b>	6.000	April 15, '24	<b>91.743</b>	1.99	88.000
Diamond Offshore Drilling	<b>DO</b>	7.875	Aug. 15, '25	<b>92.530</b>	1.28	89.500
Banff Merger Sub	<b>BMC</b>	9.750	Sept. 1, '26	<b>92.000</b>	1.00	89.875
Freeport-McMoran	<b>FCX</b>	5.250	Sept. 1, '29	<b>99.730</b>	0.98	98.062
Oasis Petroleum	<b>OAS</b>	6.875	March 15, '22	<b>93.500</b>	0.97	89.500
Penn National Gaming	<b>PENN</b>	5.625	Jan. 15, '27	<b>103.135</b>	0.89	101.500



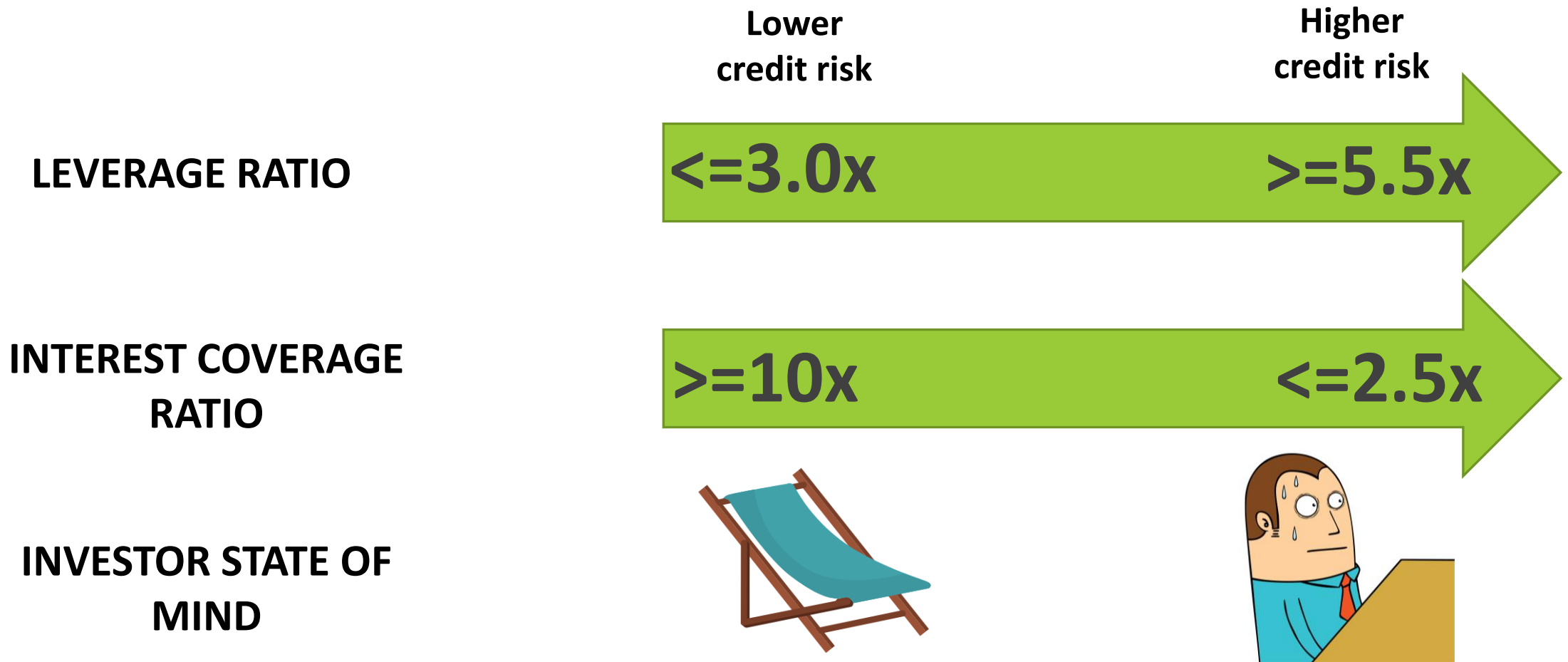
# How We Make Initial Investment Decisions

# Overlaying Credit Spreads with Financial Metrics

EBITDA	INTEREST COVERAGE RATIO	LEVERAGE RATIO
Earnings before interest, taxes, depreciation & amortization	$\frac{\text{EBITDA}}{\text{Interest Expense}}$ <p><i>Higher = lower default risk</i></p>	$\frac{\text{Long-Term Debt}}{\text{EBITDA}}$ <p><i>Lower = lower default risk</i></p>

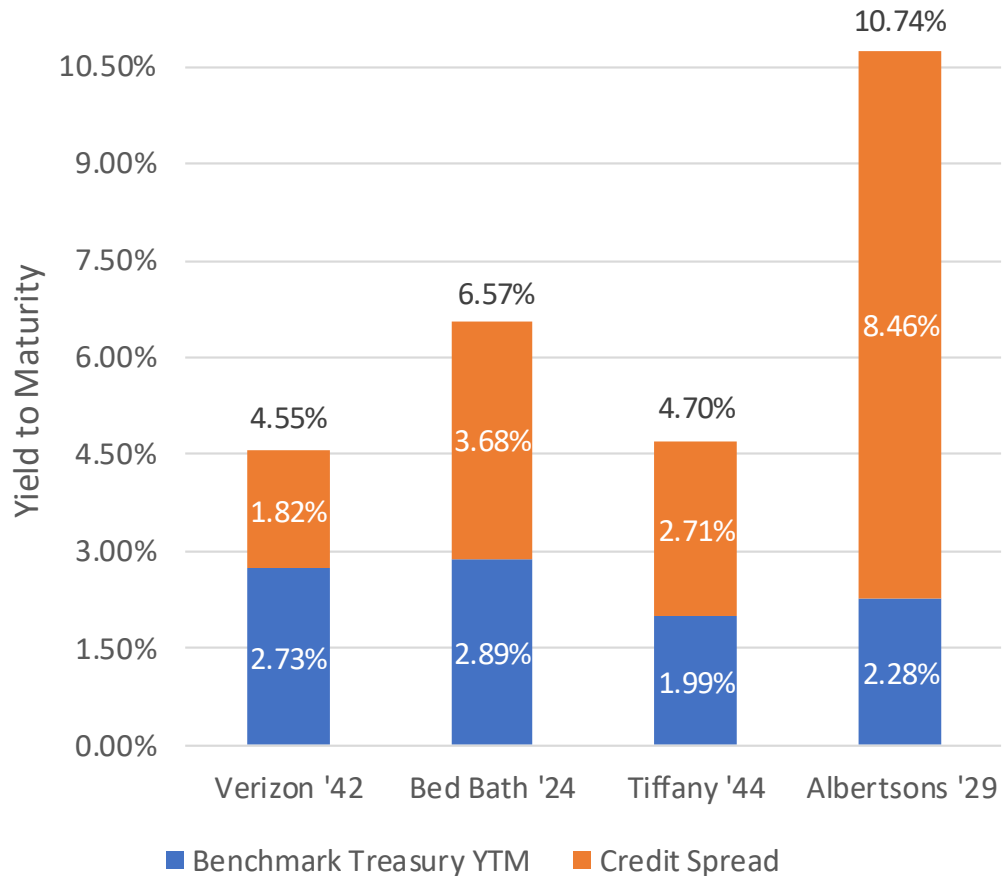
**“Purer” of the two ratios**

# Corporate Bond ‘Sweat Meter’



# Finding Value by Comparing Credit Spreads\* and Financials

Pick Date Price	89.72	85.85	103.01	78.50
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<i>\$ millions</i>	Verizon	Bed Bath	Tiffany	Albertsons
<b>Leverage Ratio</b>	2.5x	1.3x	1.0x	4.3x
<b>Cash <sup>(1)</sup></b>	\$4,583	\$724	\$681	\$813
<b>Debt <sup>(1)</sup></b>	\$124,391	\$1,500	\$1,027	\$11,754
<b>Rating</b>	Baa1/BBB+	Baa2/BBB-	Baa2/BBB+	WD**/B-
<b>Pick Date</b>	9/26/17	5/2/18	9/5/19	9/26/17

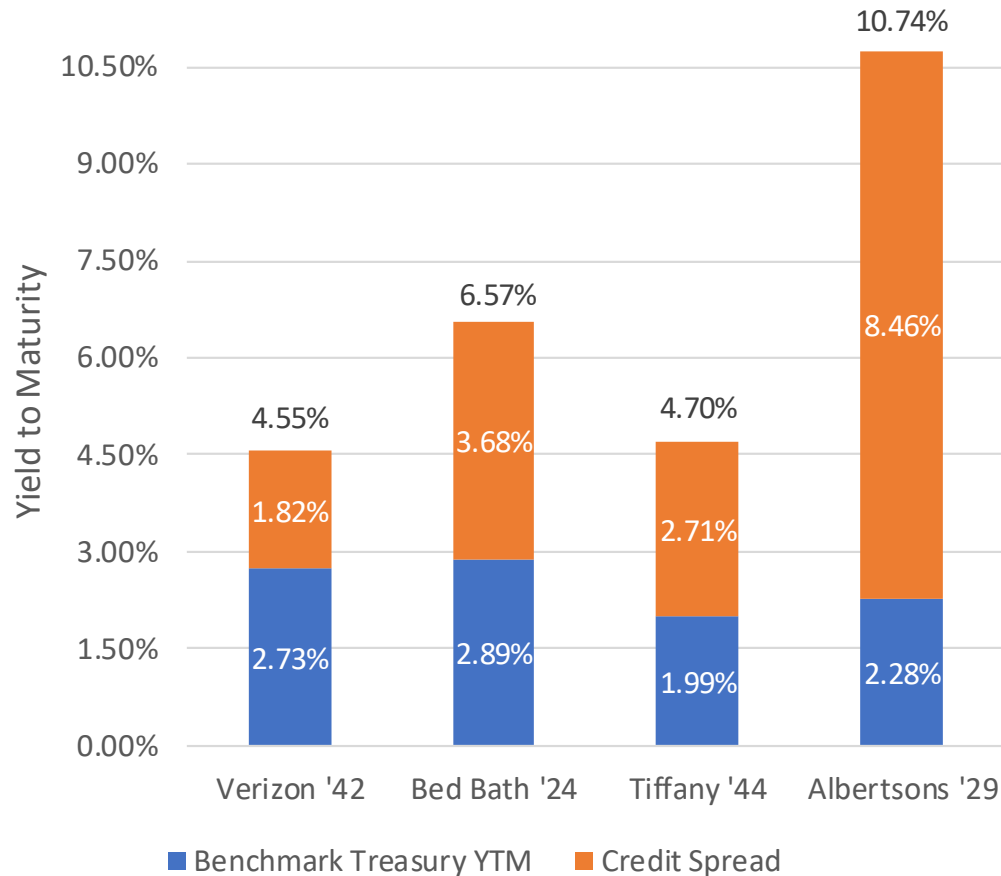


\*Bond quotes taken on Fidelity.com the day before the recommendations date. \*\*Moody's withdrew its rating 3/28/13 due to 'insufficient' information to support rating.

(1) \$ in billions. Figures calculated based on financial information as of, or for the 12 months ending on the financials reported right before the pick date.

**Understanding ‘credit value’ is key; however, investors must also understand how different bonds can react to changes in Treasury yields**

# How Credit Ratings Impact Interest Rate Sensitivity



Corporate bonds with higher credit ratings tend to have greater interest rate risk due to their:

- Longer initial maturities
- Lower coupons
- Institutional trading being indexed to the benchmark US Treasury



Treasury Yield Sensitivity  
Ranked 1-4 (1=highest)



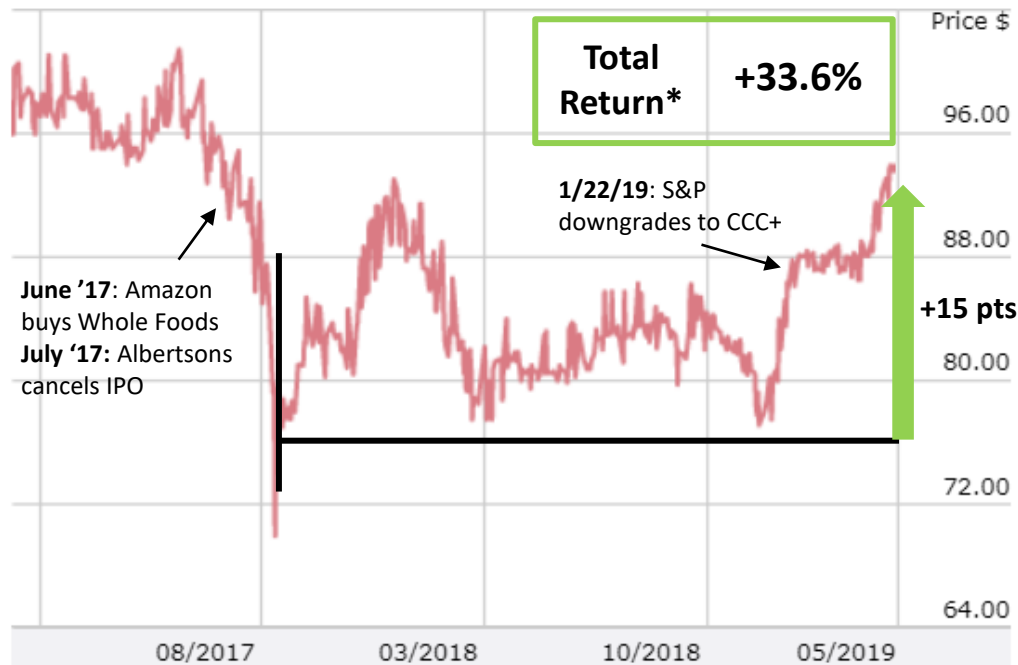


# Not All Bonds Go Down When Treasuries Fall

Even as the comparable Treasury fell 7 points, this Albertsons '29 bond returned 33.6%\* due to strong performance and reduced concern around the Amazon / Whole Foods merger

**Albertsons 7.45% 8/1/29 vs. Benchmark Treasury Price Performance – Sep 25, 2017-Apr 30, 2019**

**Albertsons 7.45% 8/1/29**



**US Treasury 6.125% 8/15/29**



**Albertsons  
Leverage  
Ratio:**

**6/17/17: 4.3x**

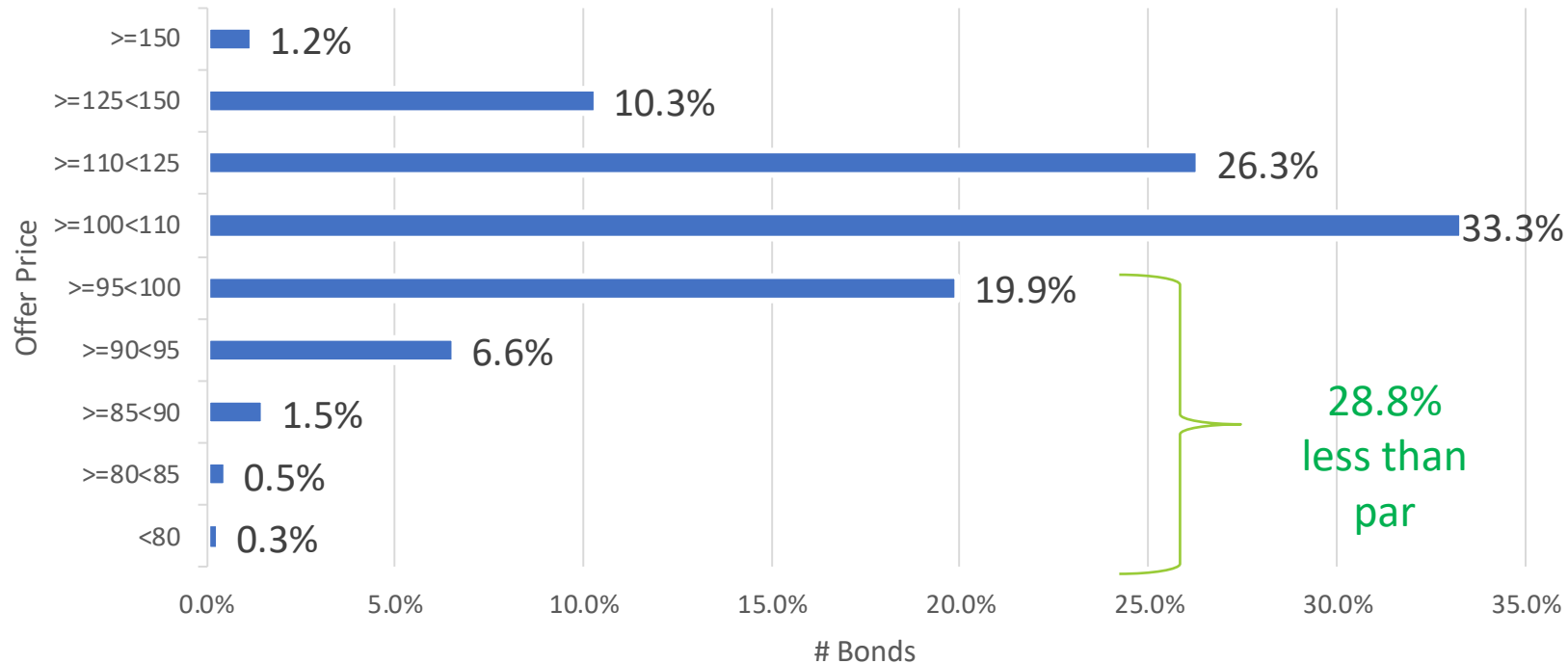
**2/23/19: 3.6x**

\* Albertsons return based on 9/25/17 offer price from Fidelity.com and 4/30/19 price from Fidelity brokerage statement. Treasury CUSIP: 912810FJ2. All other historical prices are from FINRA market data. Total returns include interest income and capital gains or losses.

# How To Invest Actively in Corporate Bonds

# Understanding Bond Price 'Ceilings'

## Investment-Grade Bond Offer Prices – 1,587 Bonds – June 13, 2019



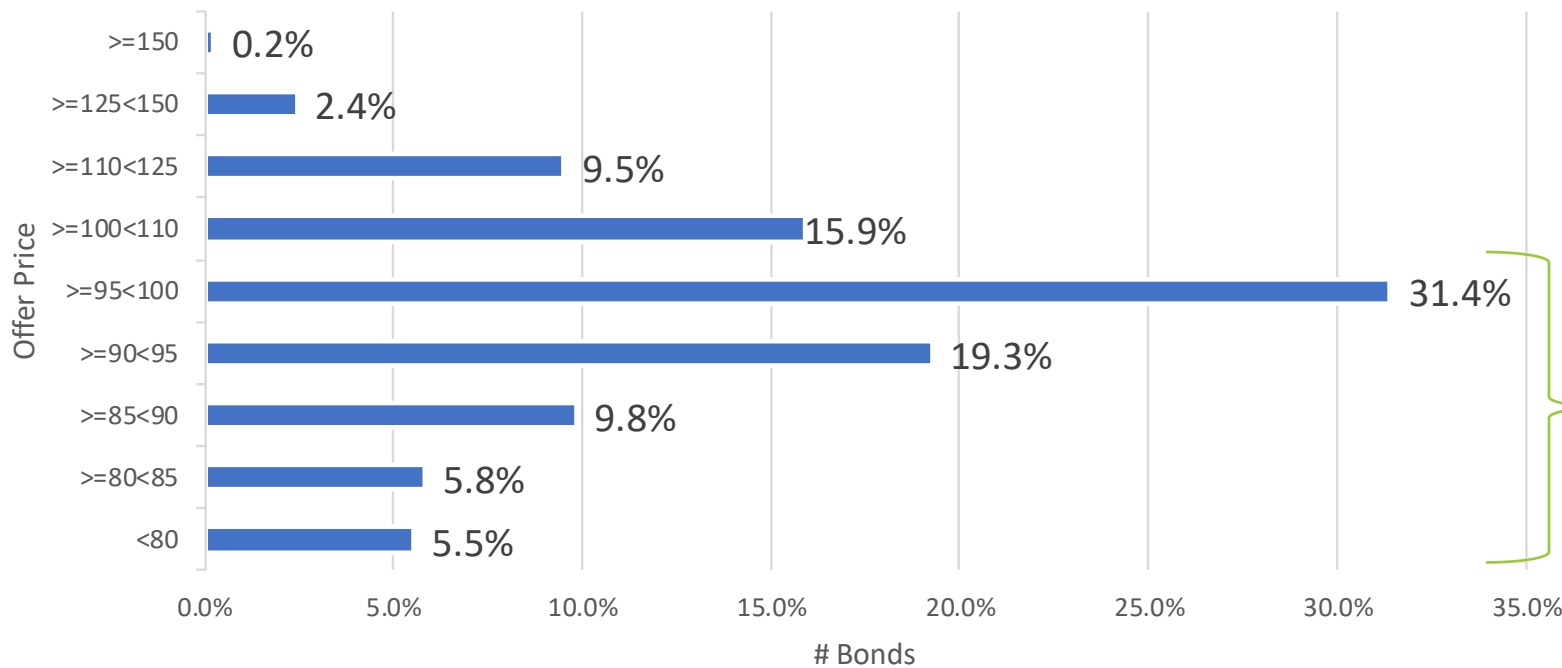
- The par-value scale is a big advantage individual bonds have over funds
- Bonds trading at a discount generally have greater upside and less downside than premium bonds

• In a taxable account, \$1 of capital gain is worth more than \$1 of interest income

• Bond prices have ceilings, which often require selling prior to maturity to maximize returns

# Lower Bond Values at Height of COVID-19 Crisis

## Investment-Grade Bond Offer Prices – 3,740 Bonds – March 19, 2020



	6/13/2019	3/19/2020
# Bonds YTM >=4%	1,587	3,740
% Bonds < Par	28.8%	71.9%

- On March 19, there were nearly 2.5x the number of investment-grade bonds that had YTM's >=4%

71.9%  
less than  
par

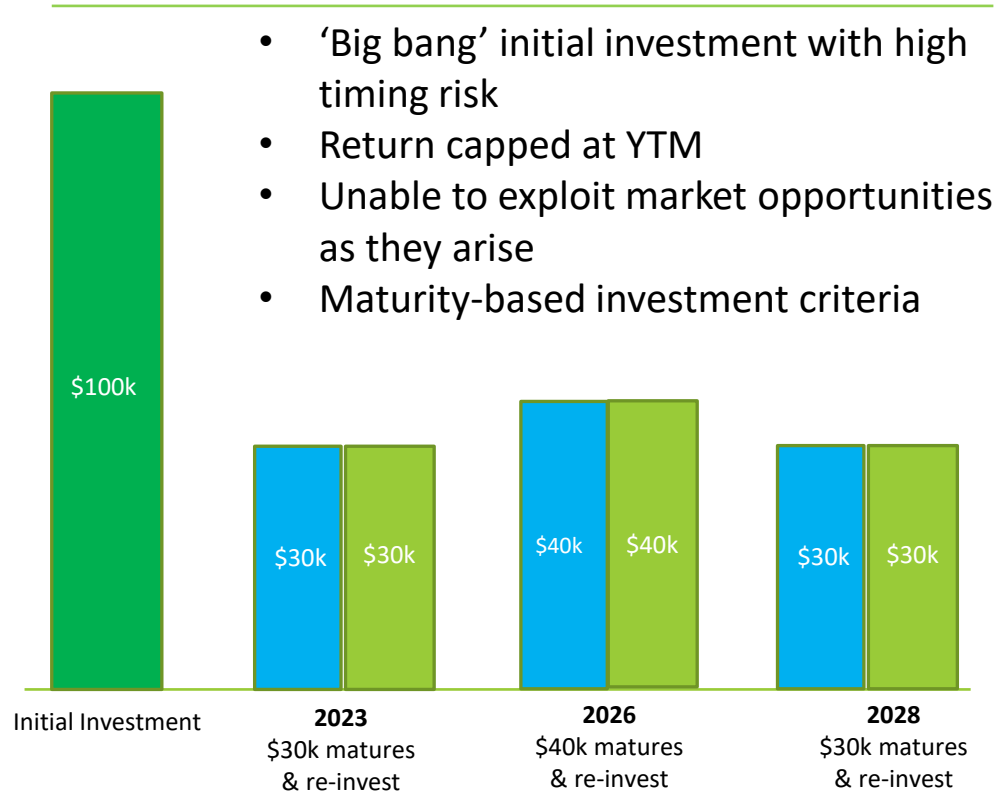
I just built a bond ladder  
in February 2020....DOH!



# Active Corporate Bond Investing vs. Bond Laddering

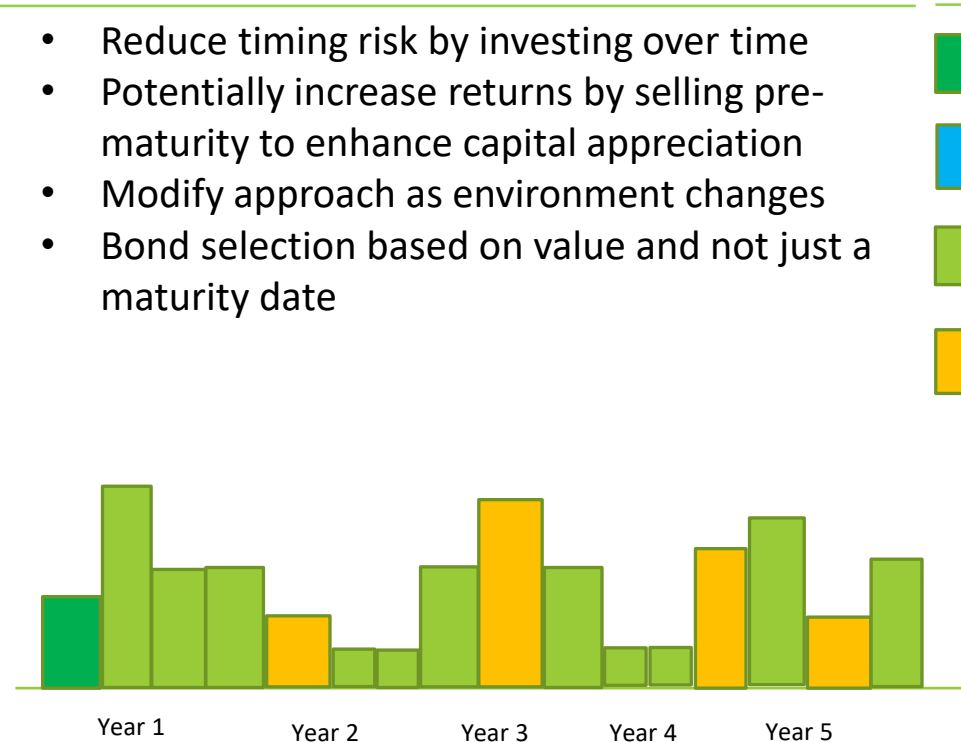
Active bond investing has a number of advantages vs. traditional bond ladders

## Illustrative \$100k Bond Ladder



- ‘Big bang’ initial investment with high timing risk
- Return capped at YTM
- Unable to exploit market opportunities as they arise
- Maturity-based investment criteria

## Illustrative Active Corporate Bond Investing



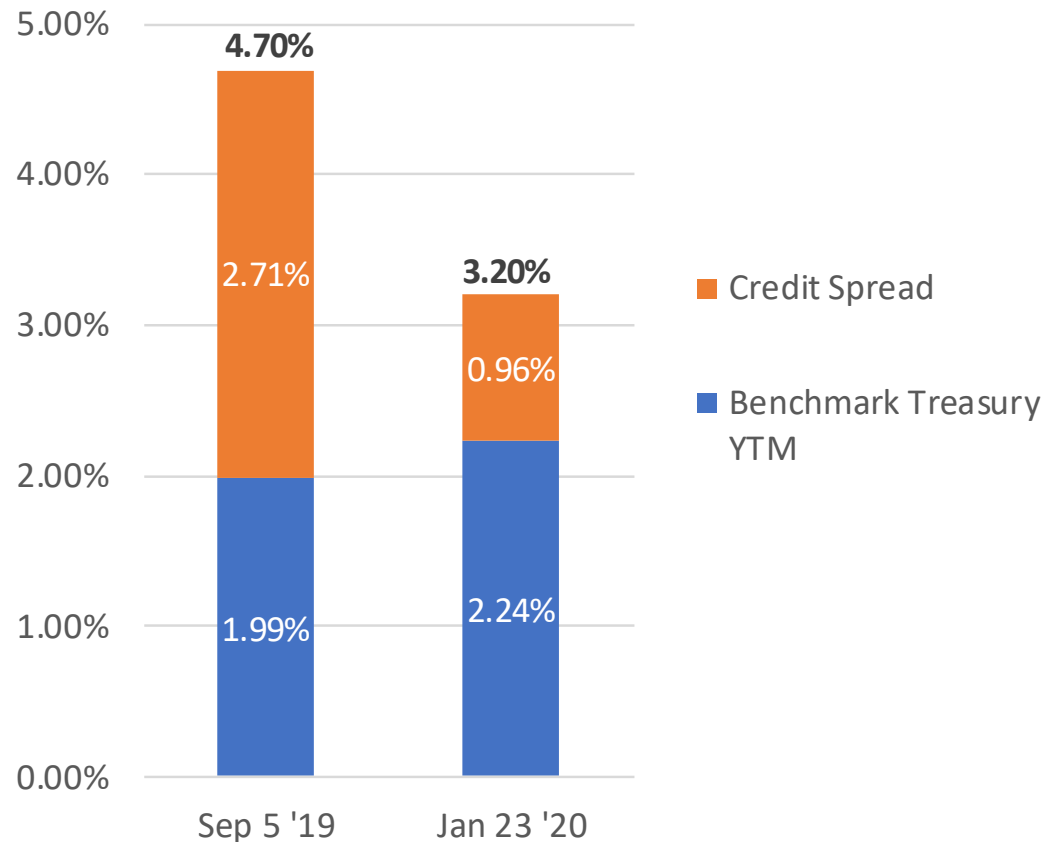
- Reduce timing risk by investing over time
- Potentially increase returns by selling pre-maturity to enhance capital appreciation
- Modify approach as environment changes
- Bond selection based on value and not just a maturity date

### Legend:



# Deciding When To Sell a Bond

## Tiffany 4.900% 10/1/44 Bond

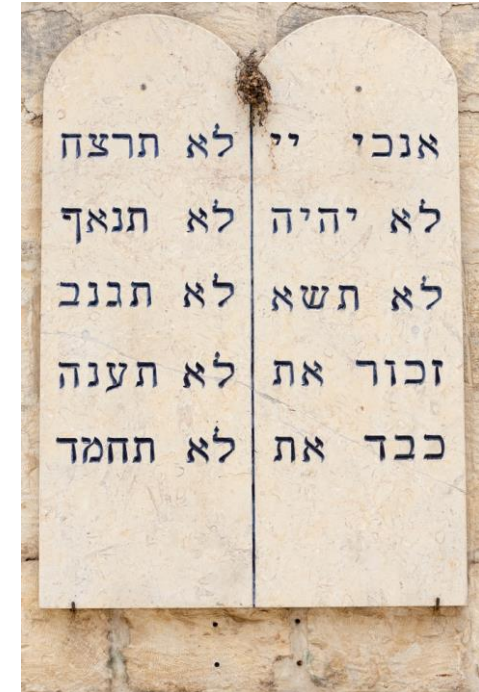


Price	103.01	128.00
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- BondSavvy recommended subscribers purchase Tiffany '44 bonds on Sep 5 '19 at an offer price of 103.01
- After our recommendation, LVMH announced its offer to acquire Tiffany and, later, an agreement to purchase Tiffany
- Many investors perceived the combined company to have a higher credit quality, which caused the bonds to surge
- Spread shrunk to a low level where we didn't believe further upside remained in the bond
- We recommended selling the bond at a 26% return

# My Bond Investing “Commandments”

- Own bonds directly to improve transparency, lower fees, and increase returns
- Own a select portfolio of bonds with compelling relative values
- Make buy / sell decisions based entirely on investment criteria and avoid bond ladders
- Vigorously protect every dollar of capital appreciation by selling prior to maturity when upside wanes
- Invest over time to capitalize on opportunities
- ‘High-yield’ bonds *can* have less overall risk than higher-rated bonds





***Investors in individual bonds  
keep learning and can improve  
performance over time***



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# Additional Q&A



Thank you and stay well!

Steve Shaw

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