

Corporate Bonds

Many corporations raise money through the issuance of bonds (debt). The funds raised through these securities are used by the corporation for a variety of purposes, such as modernization, expansions, new product ideas, and others. Currently, the corporate bond market is one of the largest fixed income markets in the world with about \$2.4 trillion outstanding in 1998. Because of its size and the fact there are thousands of different issuers, the corporate bond market offers diversification for investors seeking specific risk/reward parameters for their portfolio.

STRUCTURE

A bond is simply a debt contract between the issuer and the investor. Corporate bonds have maturities ranging typically from 1 to 30 years. Usually corporate bonds have coupons that are fixed at the time of issuance and are paid to bondholders on a semi-annual basis. When issued, a trustee is appointed, usually a bank, who acts in a fiduciary capacity for the investors, making sure the issuer complies with the protective covenants listed at issuance.

Although bonds have a stated maturity date on which they become due and payable, some bonds have provisions that may pay off the bond prior to maturity. If a bond has an optional call or a sinking fund, it may be paid off early. An optional call gives the issuer the ability to call an entire issue on a certain date. If a bond is

callable, there is usually a specified time period following the date of issuance (such as five years) during which the bonds cannot be called. A sinking fund provision requires the issuer to retire a specified portion of the bond issue each year prior to maturity. This can be advantageous to the bondholder because the systematic pay down of the bonds may lower the risk of default.

TYPES OF CORPORATE BONDS

Corporate bonds generally fall into two categories: *secured* and *unsecured*. Secured bonds (often termed collateralized bonds) are backed by a specific asset of the issuer such as: property, equipment, or other assets. Utilities are common issuers of mortgage bonds secured by their plants. Railroads are common issuers of equipment trust bonds, which are secured by locomotives or cars. A collateral trust bond is secured by certain assets such as securities which are pledged by the issuer to the trustee. In all cases of secured bonds, the trustee has the right, in the event of default, to sell the pledged assets to repay the bondholders all or part of their money.

Unsecured bonds (termed debentures) are backed by the general credit of the issuer. Apart from the railroad and utility companies, debentures are the most common type of bond issued by corporations. Financially strong companies typically issue debentures because securing their debt with specific collateral is



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viewed as excessive. Ranked below debentures are subordinated debentures, which have the weakest claims on assets and earnings of a corporate issuer. Although this debt ranks behind all other debt types, it stands ahead of preferred and common stockholders in claims made against the company in case of liquidation or bankruptcy.

CORPORATE BOND RATINGS

When purchasing a corporate bond, an investor has a legitimate and compelling need to look at the creditworthiness of the company issuing the bonds. Fortunately, several well-known commercial ratings companies perform this service. Moody's and Standard & Poor's are the best-known and most quoted. They rate almost all public companies. Duff & Phelps and Fitch are additional, smaller rating services.

The primary question in rating bonds is the issuer's predicted ability to make timely payments of interest and principal. Ratings are not recommendations as to the relative attractiveness of an issue at any given time, but offer investors a tool to judge creditworthiness. Because the rating services have historically been quite reliable, investor confidence in ratings is high. Continual reviews of company and industry ratings provide investors additional comfort. A brief explanation of bond ratings follows.

Corporate Bond Ratings

Definition	Moody's	Standard & Poor's
Highest and strongest rating assigned	Aaa	AAA
High quality by all standards, differs from highest grade only by a small degree	Aa	AA
Upper medium grade with a strong capacity to pay, but somewhat susceptible to impairment given adverse economic conditions	A	A
Medium grade with adequate capacity to pay principal and interest – neither highly protected nor poorly secured	Baa	BBB
Speculative issue with only moderate payment potential	Ba, B	BB, B
Poor quality issues that may be in danger of default, or in default, highly speculative	Caa, Ca	CCC, CC, C
Lowest rated class and is in default	C	C, D

Moody's adjusts within grades by assigning the numbers 1, 2, or 3 (1 being the highest), and S&P modifies within grades by plus (+) or minus (-). For example, a bond issue may be rated A1 by Moody's and A+ by S&P.

The top four rating categories are generally regarded as investment grade bonds because the risk of defaults on interest and principal payments is considered moderate. The bottom three rating categories are often described as speculative grade bonds (sometimes referred to as "high yield bonds") because the company's current financial position is either speculative or uncertain in its ability to make principal and interest payments.



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CONSIDERATIONS

Call Features – Before purchasing a corporate bond, every investor should know its yield to maturity and yield to call, if it's callable. If a bond is bought at a *premium* to the call price, the yield to call will be lower than it would be if the bond were allowed to mature. And if the bond is bought at a *discount* to the call price, the yield to call will be higher.

Rating – Because corporate bonds cover a broad spectrum of credit ratings, investors can tailor their investment to meet their specific risk/reward parameters. The rating will help investors with this evaluation. For instance, investment grade bonds offer investors steady income and preservation of capital. Speculative grade bonds offer investors the possibility of capital appreciation and some of the highest yields in the fixed income markets, along with a higher risk of default and volatile prices.

Taxability – Interest payment received from corporate bonds are subject to taxation at both the state and federal levels.

CONCLUSION

The corporate bond market offers investors opportunities in investment grade and speculative grade securities. Because of the vast array of bonds available, investors can often find an issue or issues that fit their specific needs. We recommend working with your RBC Wealth Management Financial Consultant to determine appropriate investment parameters and strategies for investing in corporate bonds.

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