

Active Corporate Bond Investing

Steve Shaw
Founder & President, BondSavvy

January 5, 2019





BondSavvy Disclaimer

InvestorG2 LLC d/b/a BondSavvy is not registered as an investment adviser under the Investment Advisers Act of 1940, as amended (“Advisers Act”), or the securities laws of any state or other jurisdiction, nor is such registration contemplated.

Any screenshots, charts, or company trading symbols mentioned are provided for illustrative purposes only and should not be considered an offer to sell, a solicitation of an offer to buy, or a recommendation for the security.

As BondSavvy operates under the publishers’ exemption of the Advisers Act, the **investments and strategies discussed in this presentation do not take into account an investor’s particular investment objectives, financial situation or needs**. In making an investment decision, each investor must rely on its own examination of the investment, including the merits and risks involved, and should consult with its investment, legal, tax, accounting and other advisors and consultants.

The information in this presentation is based on data currently available to Shaw, as well as various expectations, estimates, projections, opinions and beliefs with respect to future developments, and is subject to change. Neither Shaw nor any other person or entity undertakes or otherwise assumes any obligation to update this information.

There are risks inherent in investing in bonds, which may adversely affect the bonds’ investment returns. These risks include, for example, market decline, interest rate fluctuations, inflation, default, liquidity, and asset class risks. There is no guarantee that investors will be able to meet their investment objectives. **Past performance is not indicative of future results.** Investors could lose all or part of their investment in a bond, particularly when investing in a high yield bond. Investing in bonds could also produce lower returns than investing in other securities. Investing in bonds does not constitute a complete investment program.

***The S&P 500 fell 7% in October and
9% in December***

Where Should You Invest?

Here's how NOT to invest in bonds

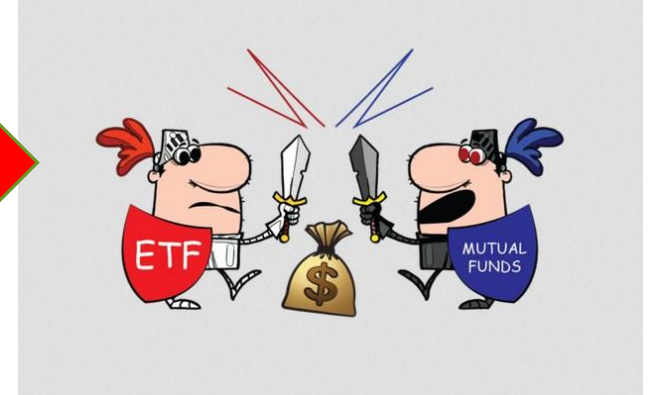
Investor



Financial Advisor



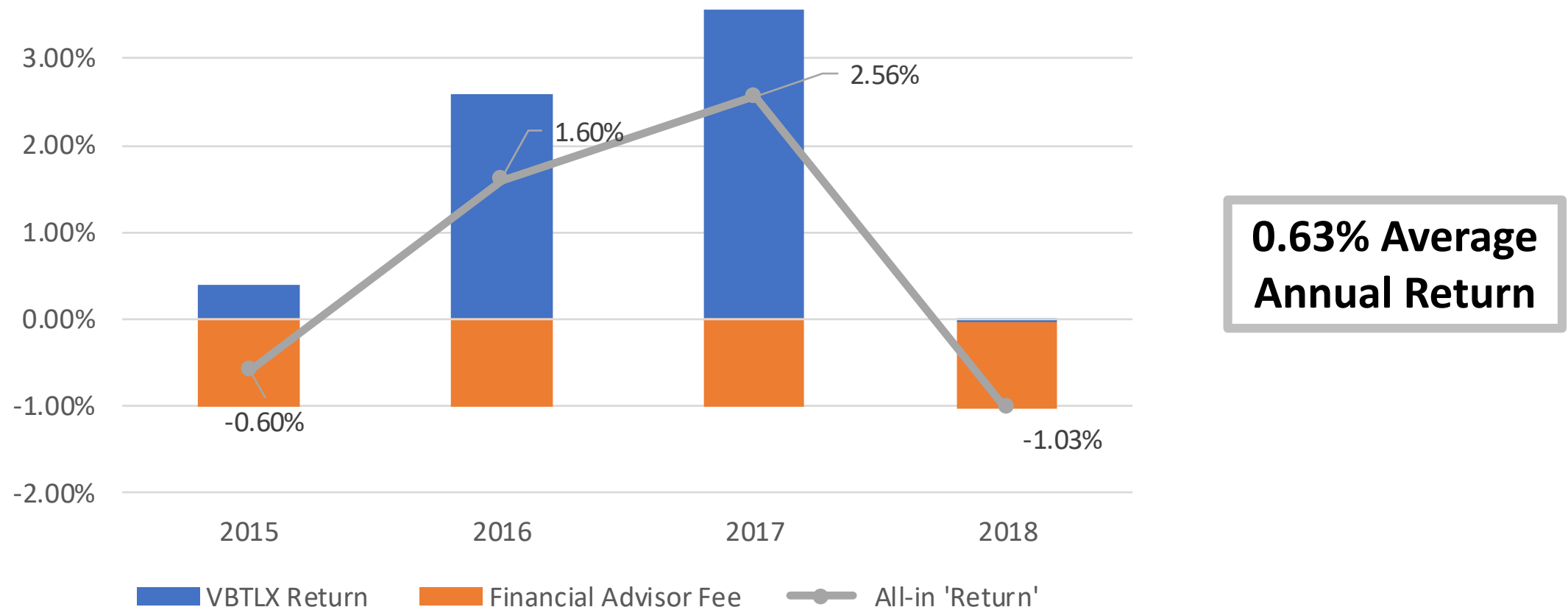
Bond Funds & ETFs



The status quo works well for Wall Street but NOT individual investors

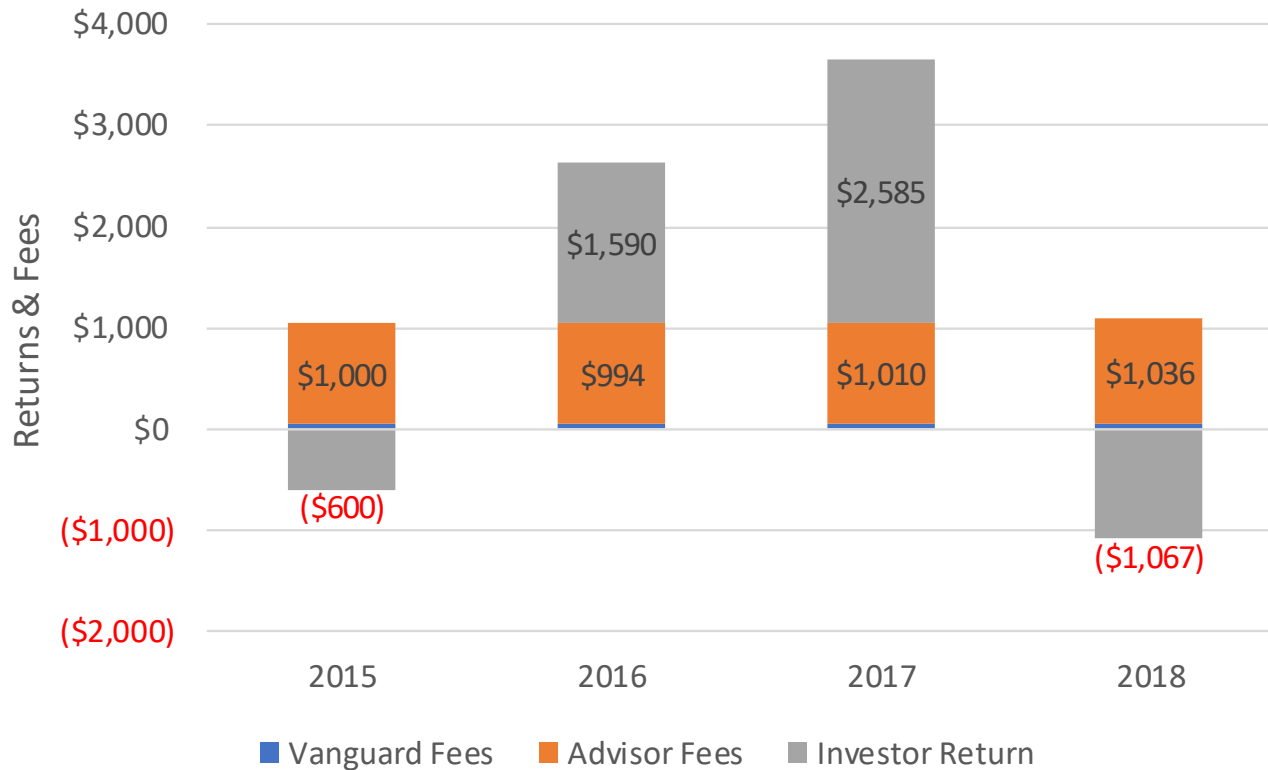
Advisors placing clients into mega index bond funds is bad for investors

% Returns for Vanguard Total Bond Market Index Fund Admiral Shares* and Advisor Fee Impact



After investing \$100k over four years in VBTLX, the investor makes \$1,531 less than his advisor

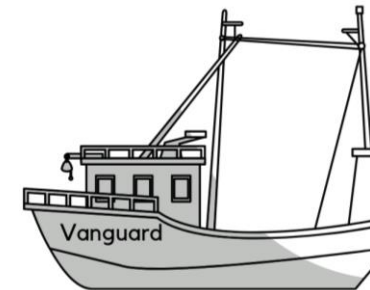
Annual Investor Returns vs. Fees Paid to Advisor and Vanguard



'15-'18 Returns



\$4,040



\$202



\$2,509

* Reflects returns of Vanguard Total Bond Market Index Fund Admiral Shares (VBTLX)

The status quo rewards service providers at the expense of the investor



It's the "Advisor to Vanguard Road to Nowhere"



***Individual corporate bonds
can increase returns but are
less than 1% of US investor
assets***

Agenda

- 1. Corporate Bonds 101 – The Basics**
- 2. Individual corporate bonds vs. bond funds and municipal bonds**
- 3. What is active corporate bond investing?**
- 4. How not all bonds fall when Treasury yields rise**
- 5. Why sell bonds prior to maturity?**
- 6. Are individual investors treated fairly when investing in corporate bonds?**
- 7. BondSavvy's process for identifying corporate bonds that can outperform the market**
- 8. Q&A**

Corporate Bonds 101 – Coupon and Maturity

Verizon **3.85%** **11/1/42**

Coupon:

- Paid semi-annually until maturity date
- \$38.50 in interest received annually for each bond owned
 - \$385 per year if owned 10 bonds

Maturity Date:

- Date at which company returns face value (“par”) to investor (\$1,000 per bond)
- Price you pay for a bond could be higher (‘premium’) or lower (‘discount’) than par value

How Bonds Are Quoted & What You Pay

Bid / Offer Quote

85.00 / 85.50

How bonds are quoted:

- Percentage of face value
- Face value of one bond is \$1,000

Sell 1 Bond for:

\$850.00

Buy 1 Bond for:

\$855.00

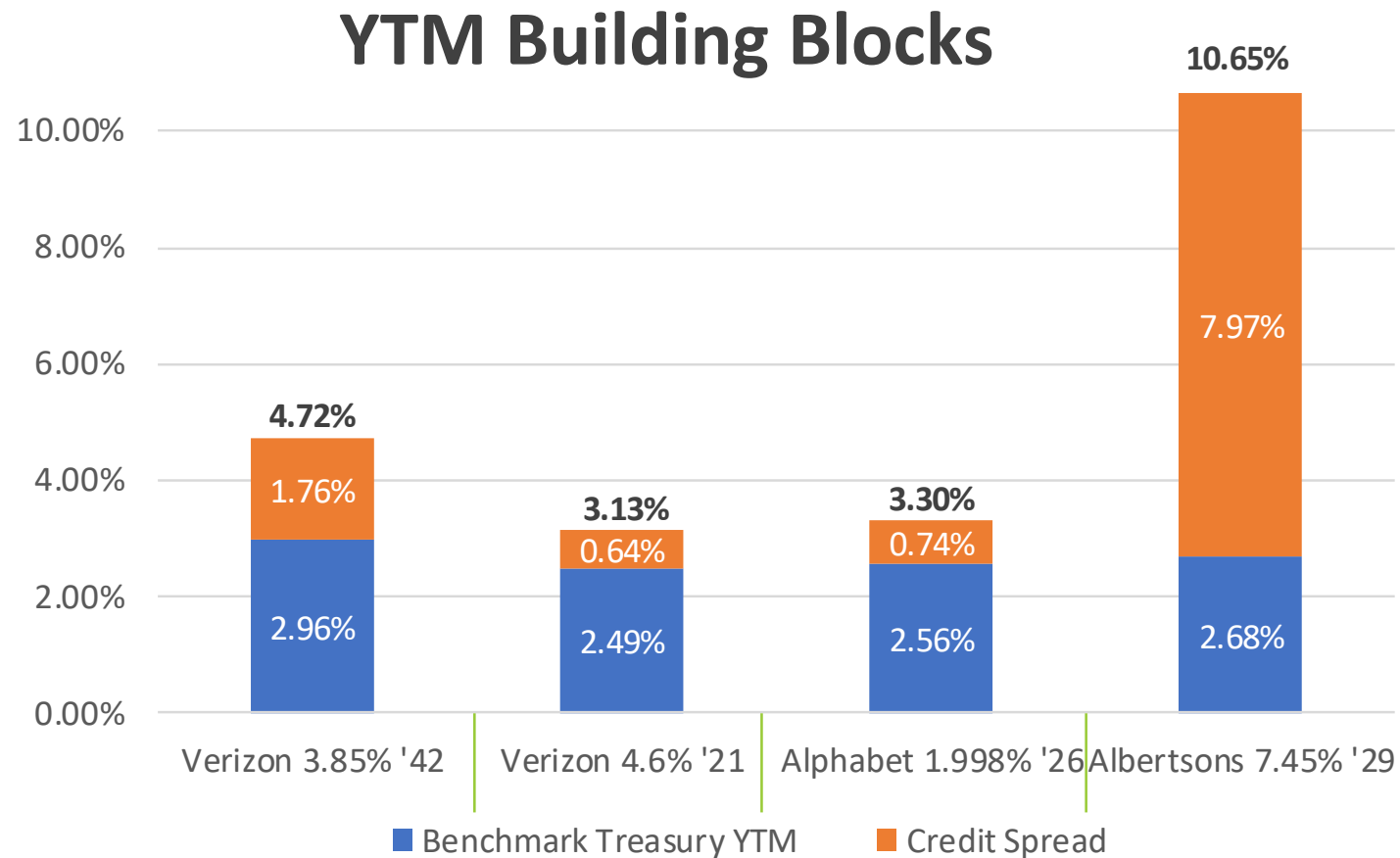
***Plus Interest Accrued
Since Last Coupon***

Current Yield vs. Yield to Maturity

Verizon 3.85% 11/1/42

Bid-Offer Quote		<u>Current Yield</u>	<u>Yield to Maturity</u>
87.11 / 87.65	If Bought at Par	3.85%	3.85%
\$876.50 to buy one bond	If Bought at 87.65	4.39%	4.72%
	Current Yield at 87.65 =	\$38.50 ÷ \$876.50	






How Treasury Yields & Credit Spreads Impact Bond Prices



$$\begin{array}{c}
 \text{Benchmark} \\
 \text{Treasury YTM} \\
 + \\
 \text{Credit Spread} \\
 = \\
 \text{Corporate} \\
 \text{Bond's YTM}
 \end{array}$$

Corporate Bonds vs. Bond Funds vs. Muni Bonds

Corporate bonds have advantages relative to muni bonds and bond funds that can make them a compelling alternative for fixed income investing

	Corporate Bonds	Municipal Bonds	Bond Funds
Highest potential returns		—	—
Highest-quality financial disclosures		—	—
Lowest all-in cost of ownership		—	—
Easiest to buy and sell		—	—
Best able to assess value		—	—

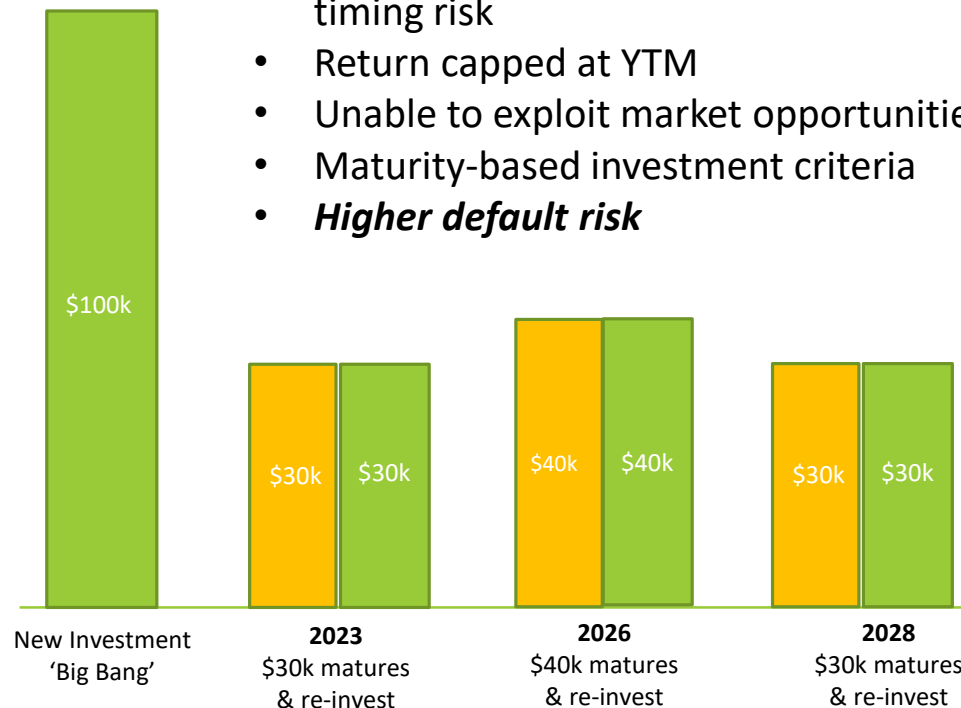
So How Should You Invest in Individual Corporate Bonds?

Active Corporate Bond Investing vs. Bond Laddering

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

Illustrative \$100k Bond Ladder

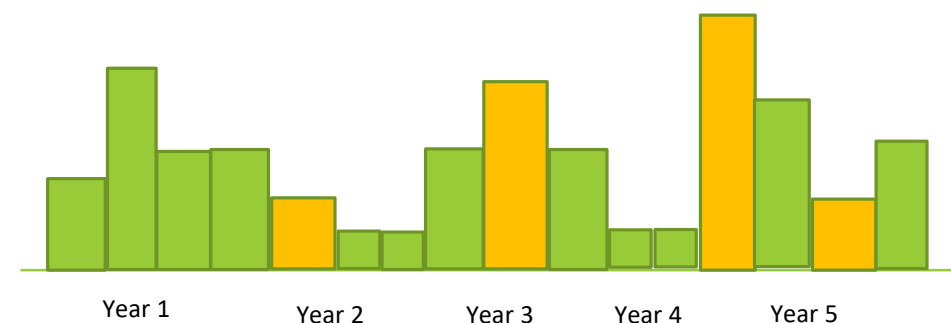
- 'Big bang' initial investment with high timing risk
- Return capped at YTM
- Unable to exploit market opportunities
- Maturity-based investment criteria
- **Higher default risk**



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:



Why Is Active Corporate Bond Investing Important?

Active corporate bond investing positions investors to capitalize on market dynamics that can work to their advantage



- Not all bonds are sensitive to interest rates, and investors should adjust accordingly



- Bond prices have ceilings and investors should sell once return is maximized







- Buy as prices fall due to often irrational selling:
 - Follow-the-herd investors selling when bonds are downgraded
 - Forced selling driven by bond fund and ETF redemptions
 - Overreactions to a bad quarterly earnings report



- Successfully navigate tender and/or exchange offers

What Active Corporate Bond Investing Is and Is Not

Active Corporate Bond Investing IS NOT

- 
- 
- 
- 
- Day trading
 - Selling as soon as a bond goes up 10 points
 - Selling as soon as a bond goes down 10 points
 - A slick computerized algorithm

Active Corporate Bond Investing IS

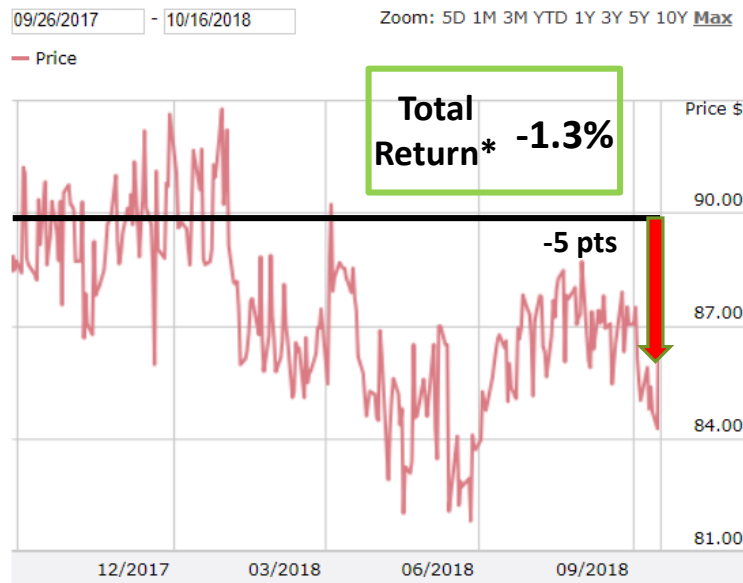
- Generally 2- to 4-year holding period
- Seeking to maximize annualized total return for each bond – the longer the period, the better
- Making initial investment and adding to it if risk/return opportunity improves
- Careful analysis of each issuer and bond to identify investment opportunities

Corporate Bonds Don't Always Move in Lockstep with Treasuries

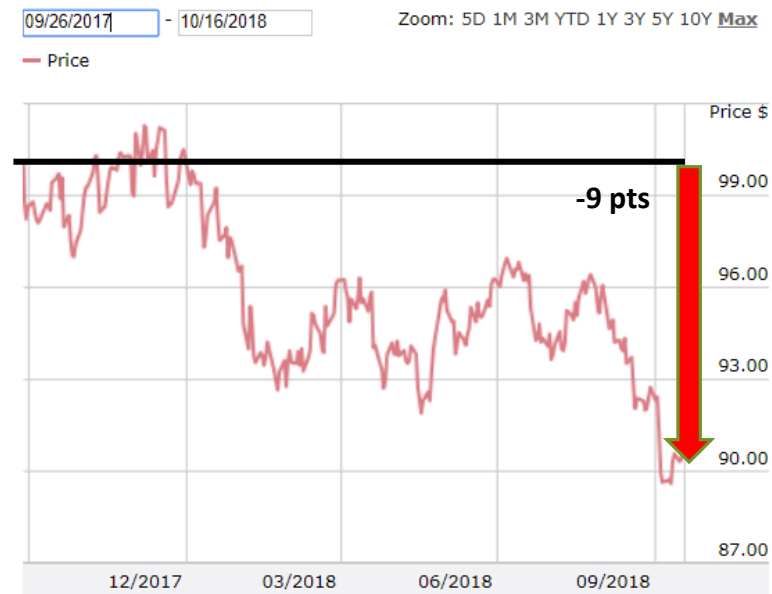
Investment-grade and high-yield corporate bonds react differently to changes in Treasury yields, which is why investors should consider investing actively over time

Verizon 3.85% 11/1/42 vs. Comparable Treasury

Verizon 3.85% 11/1/42



US Treasury 2.75% 11/15/42



Source: Historical Verizon '42 and US Treasury prices are from FINRA market data.

* Verizon return based on top-of-book bid price available on E*TRADE October 16, 2018 at 3:00pm EDT and market price on September 26, 2017.

Not All Bonds Go Down When Rates Increase

Even as the comparable Treasury fell 12 points, this Albertsons '29 bond had returned 19%*, due to strong performance and reduced concern around the Amazon / Whole Foods merger

Albertsons 7.45% 8/1/29 vs. Comparable Treasury

Albertsons 7.45% 8/1/29



US Treasury 6.125% 8/15/29



* Returns are from September 26, 2017 through October 16, 2018. Oct 16 price based on top-of-book bid price available on E*TRADE at 3:00pm EDT. All other historical prices are from FINRA market data

How BondSavvy Approaches Credit Ratings

While credit ratings don't speak to the value of a bond, investors must understand ratings momentum given how strongly ratings changes impact bond prices

- Thousands of bonds have the same rating
- Many investors react to rating upgrades (by buying) and downgrades (by selling), which creates opportunity
 - Ratings can, at times, go years without changing, which provides investors who regularly review updated financials a leg up
- Prior to investing, BondSavvy reviews upgrade and downgrade notes to understand potential causes and likelihood of rating changes
 - Investors must be 'extra sure' about BBB- investments given pricing decrease resulting from downgrade to non-investment-grade

S&P Ratings Distribution*

S&P Rating	# Bonds
BBB+	379
BBB	322
BBB-	183

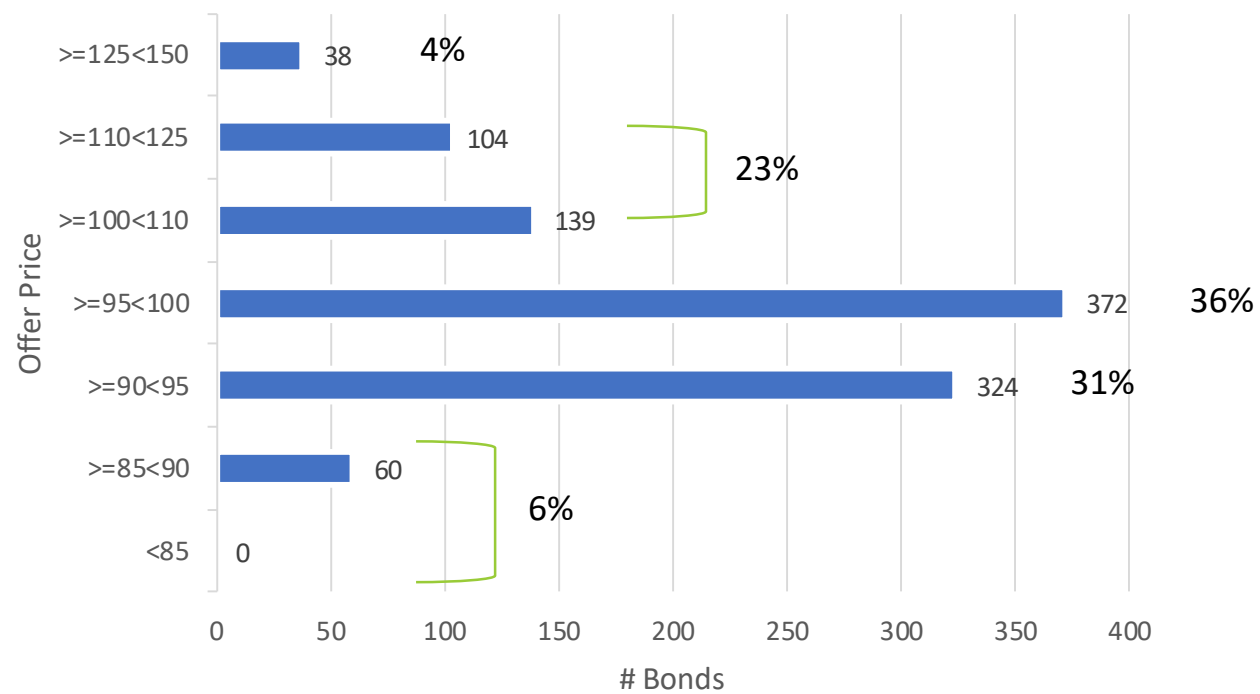
Bond investing isn't about where the issuer is today, but where it's going to be.

Enron, Sears and WorldCom were once investment-grade companies.

Corporate Bonds Have Price Ceilings

If a bond goes up materially in price, investors should consider selling the bond to lock in the return



Investment-Grade Bond Offer Prices – 1,037 Bonds YTM 4.25+%*



- Few bonds trade above 125
- Locking in capital appreciation is especially important for lower-coupon bonds that can't 'out-yield' a fall in price
- Bonds trading at a discount generally have greater upside and less downside than premium bonds

How Selling Prior to Maturity Can Bolster Returns

Selling bonds prior to maturity can help investors lock in capital appreciation and achieve returns higher than a bond's yield to maturity, as shown in the below examples*

<u>Bond</u>	<u>Bond Price: Investment Date vs. Sell Date</u>	<u>Investment Date YTM</u>	<u>Annualized Return Through Sale</u>
Apple 3.850% '43 Purchased: 10/28/13 Sold: 5/9/18	 85.07 95.32	4.8%	6.4%
Cablevision 5.875% '22 Purchased: 12/8/15 Sold: 1/9/18	 79.25 99.12	10.1%	17.6%

Please note: Selling bonds prior to maturity will not always result in returns in excess of the bond's Yield To Maturity. Selling prior to maturity may result in lower returns than if the bond was held through to maturity.

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

Liquid Market That Enables Active Investing

Corporate bonds trade in a competitive, two-sided market compared to muni bonds, which typically have only one quote on the offer side and no live bid-side quote

- This Alphabet bond had 8+ dealers quoting and a bid-ask spread of 0.34 points (5 bps)

Alphabet 1.998% '26 – Depth of Book*

BIDS				
Qty	Min Qty	Price	Yield	
200	15	88.650	3.683	
250	10	88.646	3.684	
100	9	88.613	3.689	
99	10	88.483	3.71	
200	2	88.470	3.712	

OFFERS				
Qty	Min Qty	Price	Yield	
383	10	88.991	3.629	
99	10	89.010	3.626	
500	10	89.024	3.624	
14	2	89.052	3.619	
150	15	89.060	3.618	

* Alphabet 1.998% '26 depth of book shown on E*TRADE at 3:00pm ET on October 19, 2018.

Competitive Marketplace in High-Yield as Well

The bid-ask spread is slightly wider for the Albertsons '29 bond – 1.20 points – compared to the Alphabet bond, but it's still a competitive market with 6+ dealers quoting

- Certain bonds, especially those with long durations, can have wider dollar-price spreads
- This can impact holding periods since investors will need to 'overcome' this through yield or capital gain

Albertsons 7.45% '29 – Depth of Book*






BIDS			
Qty	Min Qty	Price	Yield
250	15	85.550	9.63
25	20	85.362	9.661
250	1	85.100	9.706
50	10	85.000	9.722
500	10	84.600	9.79
100	10	83.000	10.066
100	10	79.388	10.715

OFFERS			
Qty	Min Qty	Price	Yield
250	5	86.750	9.431
100	1	87.000	9.39
10	10	87.092	9.375
500	10	87.370	9.329
100	1	88.000	9.227
20	1	99.100	7.571

Minimum quantities are retail-investor friendly

Corporates Better Suited to Active Investing Than Munis

Corporate bonds have a number of attributes that make them better suited to active investing than municipal bonds

	Corporate Bonds	Municipal Bonds
Live, two-sided quotes		—
More trades per CUSIP		—
More frequent financial disclosures		—
Narrower bid-ask spreads		—
Greater variety of credit profiles		—

While competitive markets are a good thing, investors need to make successful investment decisions for this to matter.

How We Begin Narrowing Down Bonds

The below search* returned 1,037 unique CUSIPs

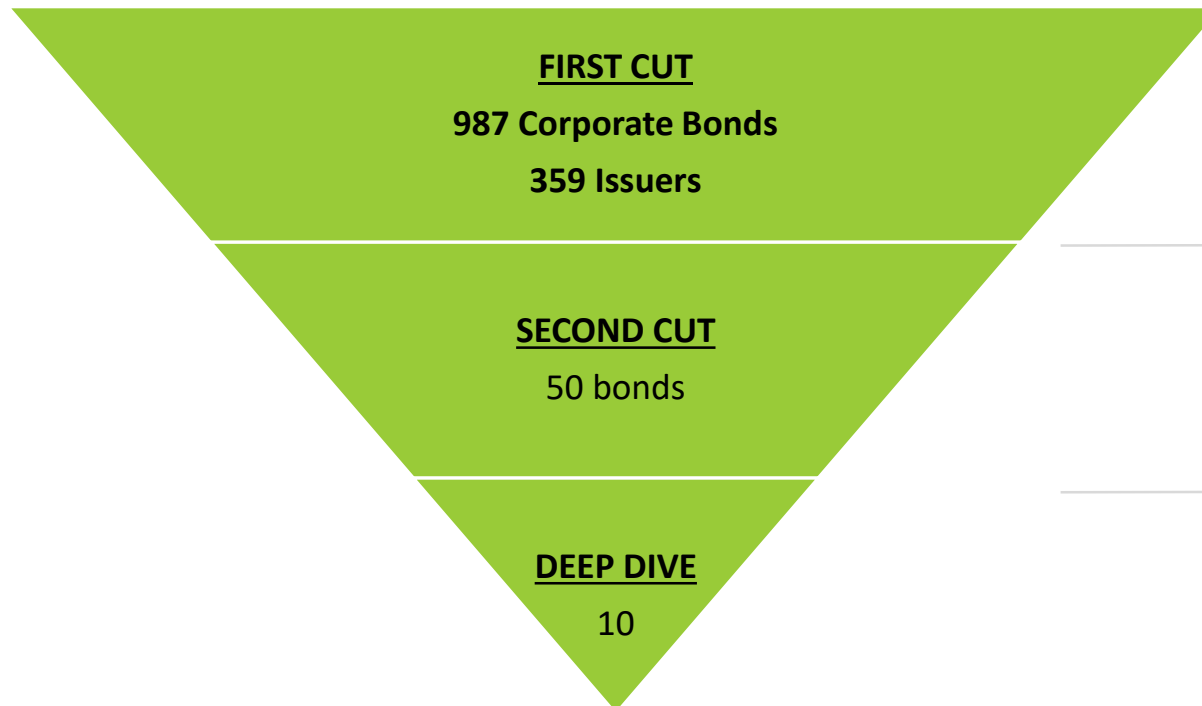
SECURITY	
Security Type ?	Security: Corporate ▼ Categories: Industrial, Utility, Financial, Telephone, Transportation ▼
Quantity ?	Min \$ 10 ,000
Maturity Date ?	From 5y
Credit Rating ?	Moody's: Min Baa3 ▼ S&P: Min BBB- ▼
Price ?	Min
Yield ?	Min %
Yield to Maturity ?	Min 4.25 %

...Luckily, the number of different issuers is smaller and we can further narrow down based on our expertise

Criterion	Unique CUSIPs	# Issuers
YTM 4.25+%, 5-15 maturity	1,037	374
Remove 'out of scope' investments (pharma, oil & gas)	<u>50</u>	<u>15</u>
First Cut	987	359

Finalizing Investment Decisions

Three-Step Filtering Process



4 New Bond Investments

Components of Each Step

- Corporate bond search
- Sector focus: telecom, media, retail, tech, ecommerce, industrials, financials (exc. insurance)
- Assess risk/reward based on pricing, yields, liquidity and knowledge of issuers
- Review SEC filings, listen to earnings calls, conduct news searches
- Compare credit ratios, growth, upcoming maturities, financial covenants, etc.

Key Terms To Evaluate Bonds

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>

Corporate Bond 'Sweat Meter'



LEVERAGE RATIO

$\leq 2x$

$\geq 6x$

**INTEREST COVERAGE
RATIO**

$\geq 10x$

$\leq 2.5x$

How We Assess Risk and Return

When evaluating the Albertsons '29 and Verizon '42 bonds, we believed both bonds had upside and fairly compensated investors for the risk they were taking

Bond and CUSIP	Ask Price	Yield to Maturity	Spread to Treasury	Leverage Ratio	Interest Coverage Ratio
Albertsons Inc. 7.45% 8/1/29 013104AF1	78.40	10.74%	8.46%	4.3x	3.1x
Verizon 3.850% 11/1/42 92343VBG8	89.62	4.55%	1.82%	2.5x	11.7x

What Else Do We Evaluate?

Apart from comparing credit ratios and credit spreads, we analyze:

- Upcoming debt maturities
- Revenue and EBITDA growth
- Ratings momentum
- Financial covenant headroom
- Liquidity in specific bond
 - Number and size of quotes
 - Trade frequency
- Bond's term premium vs. Treasury curve
- Relative seniority of bond

Key Takeaways

- New opportunities present themselves over time – not all at once
 - New earnings releases
 - Merger & acquisition activity
 - Ratings changes and fund flows can move markets (not always rationally)
- Since bond prices have ceilings, selling prior to maturity can help increase returns
- Active bond investing does not mean ‘day trading’
- Higher-rated bonds may have less default risk but don’t necessarily have less overall risk

Online bond investing is a competitive and transparent market where individual investors can use active corporate bond investing to help increase returns

Go Ravens!





Thank you

Steve Shaw

steve@bondsavvy.com

(201) 748-9862

FOR MORE INFORMATION:

WWW.BONDSAVVY.COM

Q&A