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Curves (part 5) – the offensive decides the match

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Football has two strategies. Some prefer focusing on the defensive so as not to concede a goal – i.e. they try to maintain the status quo. Other teams favour the offensive and actively engage in a fight for victory – i.e. they take risks. The strategies on the bond markets are similar. Credit-safe government bonds are preferably used to protect one's wealth, whereas risky corporate bonds are chosen to produce surplus gains.

In the past blog entries of this series we have looked at government bonds and their spreads for different maturities, investment markets, and ratings. In this article, we want to focus on the bonds issued by companies, i.e. corporate bonds.

Corporate bonds vs. government bonds

When the German government issues bonds, the individual issues differ for example in terms of maturity or coupon. The issuer, on the other hand, remains the same for every bond – this means the quality of the issuer is easily established via the rating.

Corporate bonds are issued by companies that operate across different countries and sectors. But a company may go bankrupt. This means that the redemption of the bond depends on the rating of the respective company. Much more important than the nominal interest rate or the yield of the bond is how safe the redemption at the end of maturity is. The evaluation of the ability and willingness of the company to pay the coupon in a timely fashion and to fully redeem the nominal value is a process usually carried out by specialised institutes (rating agencies) and results in a rating for the company.

Rating categories

There are several rating agencies that scrutinise the bonds of issuers and award a rating. It can range from top levels (AAA) to the risk of default (C). The two basic categories are:

- Investment grade "AAA" to "BBB-"
- Non-investment grade (i.e. high yield) "BB+" and below

The corporate spread as risk indicator

The lower the rating of a company is, the higher the risk of default. In order to compensate for this risk, investors demand a higher interest rate. The assessment of the extent of the corporate bond spread requires a credit-safe reference as basis. For the European bond market, we have selected the government bonds with the best rating, i.e. the ones issued by the Federal Republic of Germany.

Spreads on the European corporate bond market

The following chart shows that higher risk comes with higher yields. The benchmark (i.e. basis) is the yield of the German 5Y government bond (because many corporate bonds have a medium-term maturity).

The upper part of the chart illustrates the yield for European corporate bonds with different ratings of BBB, BB, and B. This is the average of many bonds from the respective segment (illustration based on a representative index).

- The lower the rating, the higher the yield

- Yields fluctuate over time
- Basis: 5Y German government bond (blue line)

The lower part of the chart (along the colours of the upper part) shows the spread of the respective rating segment.

- The corporate spreads fluctuate over time
- The spread is currently higher than the yield, because the yield of the German government bond as basis is currently negative

Why do investors need this information?

The bonds issued by companies represent a very inhomogeneous investment category. There are numerous issuers and maturities. Classifying bonds by rating segment and looking at the yields and spreads can help in the decision-making process in favour of or against a specific investment. It is important to keep in mind that a lower rating comes with a higher probability of default. This means that the number of bonds in a portfolio should also be accordingly higher (i.e. diversification). Diversified investment opportunities in specific rating segments or across ratings are offered for example in the form of selected investment funds. Prior to deciding on an investment, the investor should check the rating of the potential investment vehicle (e.g. average rating in a selected fund).

Conclusion:

Avoiding the concession of a goal, or in this context the focus on credit-safe investments, does not yield particularly high returns in an environment of zero percent interest rates. Corporate bonds, ideally as broadly diversified fund, offer an alternative.

When investing, taking risks without protection (i.e. investing exclusively in a high-risk segment) does not automatically yield the desired results. It is the individual mix that paves the way to success.

Corporate spread management is part of the active management of the funds of Erste Asset Management.

For more information on the product range of Erste Asset Management, please visit our homepage at www.erste-am.at

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Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The “1x1 of Investment Funds” that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on “banks” and “securities”. After completing his master’s degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: “Only a day with laughter is a good day”