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How to invest in corporate bond funds

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When a company needs capital, it can source it from its bank as a loan, or it can issue a bond and thus raise capital from investors on the capital market. The upside of corporate bonds, from the investors' perspective, is the fact that they usually pay a high interest rate (coupon) than government bonds of comparable maturity.

But investors who want a higher interest rate usually also have to take higher risks. With every company there is always the risk of default – and it is precisely this risk that the interest rate premium over government bonds, also called spread, is supposed to cover.

Instead of looking for individual corporate bonds, one can simply invest in corporate bond funds. Therefore, we would like to look at the following aspects in this article:

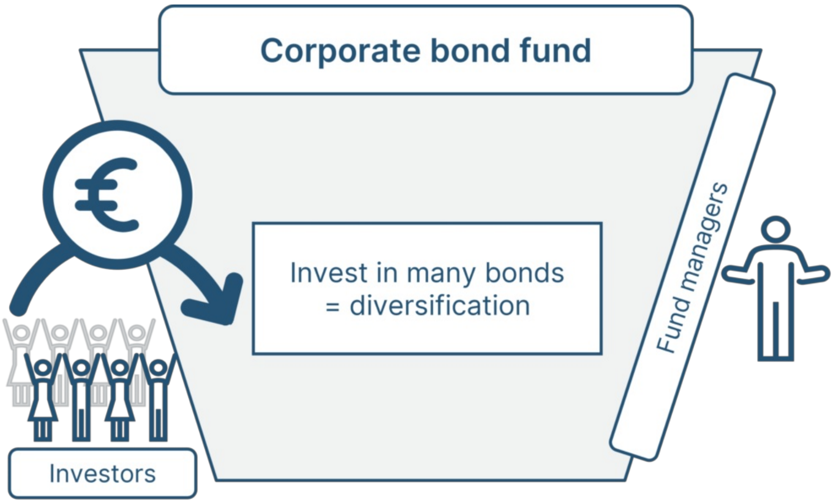
- What does a corporate bond fund do?
- Investment grade or high yield – it all depends on the rating!
- What should the investor bear in mind when investing in corporate bond funds?

Corporate bonds – a short overview

A corporate bond fund is launched and managed by an investment company. The fund usually does not have a set maturity but is designed for the long term. Investors can therefore invest in such a fund at any time.

The most important key points of a corporate bond fund are:

- Bundling of capital from many investors
- Allocation of the paid-in capital across many different bonds (issuers, countries, sectors, maturities) in order to spread the risk
- Experts (fund managers) select the bonds for the respective fund and take care of (i.e. manage) the portfolio (e.g. reinvestment when a bond has been redeemed)



Several aspects make a corporate bond fund interesting to investors:

- Investment already possible with small amounts
- Capital accumulation possible through a fund savings plan (monthly payments)
- Risk diversification, as the fund invests in bonds from different issuers

That being said, investors should always bear in mind the potential risks of such an investment:

- Issuers could get into trouble
- Bond funds tend not to come with a capital guarantee
- Capital loss is also possible for longer holding periods

Investment grade or high yield – it all depends on the rating

A corporate bond represents a loan granted to a company. And as with any loan, the borrower (in the case of corporate bonds, the issuer of the bond) must repay the principal at the end of the term and make the promised interest payments during the term.

It thus depends on the creditworthiness of the issuer whether all obligations can be met in full and on time. The creditworthiness, or in this case, rating, is usually assessed by independent rating agencies. A rough distinction is made between the following rating segments:

- Investment grade (very good to medium rating)
- High-yield (high-yield bonds, low rating)

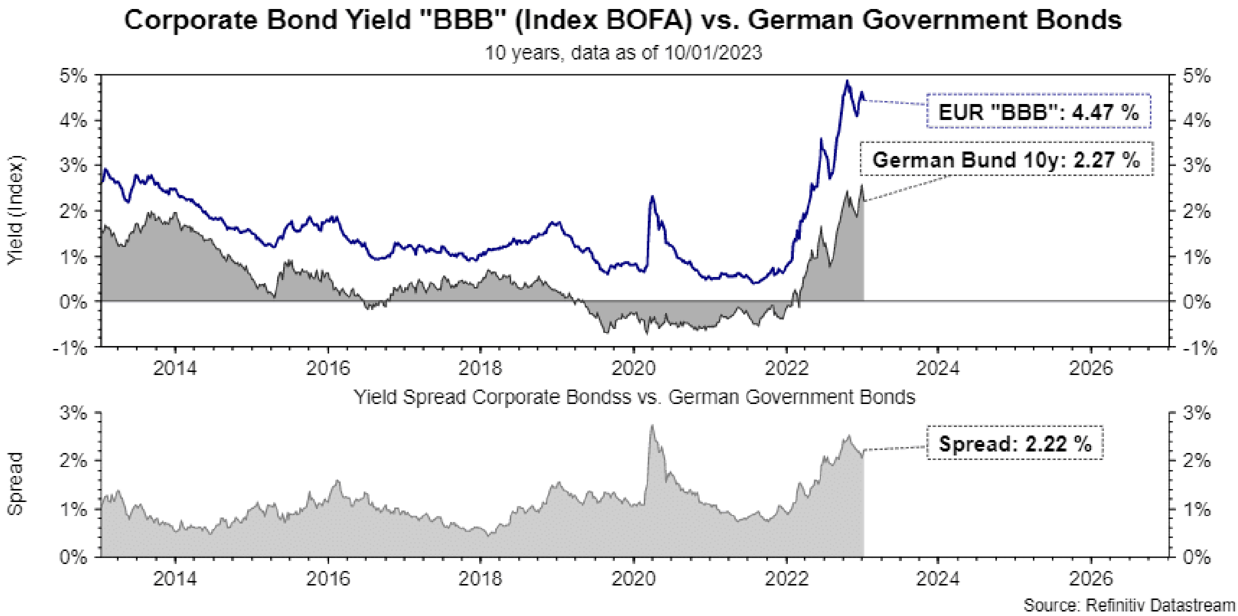
For investors, this means that prior to an investment in a corporate bond fund, one's own risk preference should be defined. One should not only look at the coupon of the bond or the yield of the bond fund. Because higher interest rates usually mean a higher risk for the capital invested and for the possible interest payments (default risk).

Investment grade – attractive or not?

Investment grade includes all credit rating segments from very good to medium. The probability of default is rather low. To assess the attractiveness of this asset segment, it is worth taking a look at:

- The yield of the security (in nominal terms)
- The spread in comparison with a credit-safe government bond (with comparable maturity)

The following chart illustrates these two aspects:



Chart, above: BBB Eurozone corporate bond yield (BOFA indices) in comparison with the yield of 10Y (i.e. 10Y remaining time to maturity) German government bonds

Below: yield differential corporate bonds vs. German government bonds

Source: Refinitiv Datastream, 10Y, data as of 10 January 2023

Note: Past performance is not reliable indicator of future performance.

The chart shows data of the index of a selected rating sub-segment from the investment grade segment in the Eurozone. Bonds from this segment are very popular among corporate bond funds. The time series goes back ten years. Two important conclusions can be drawn:

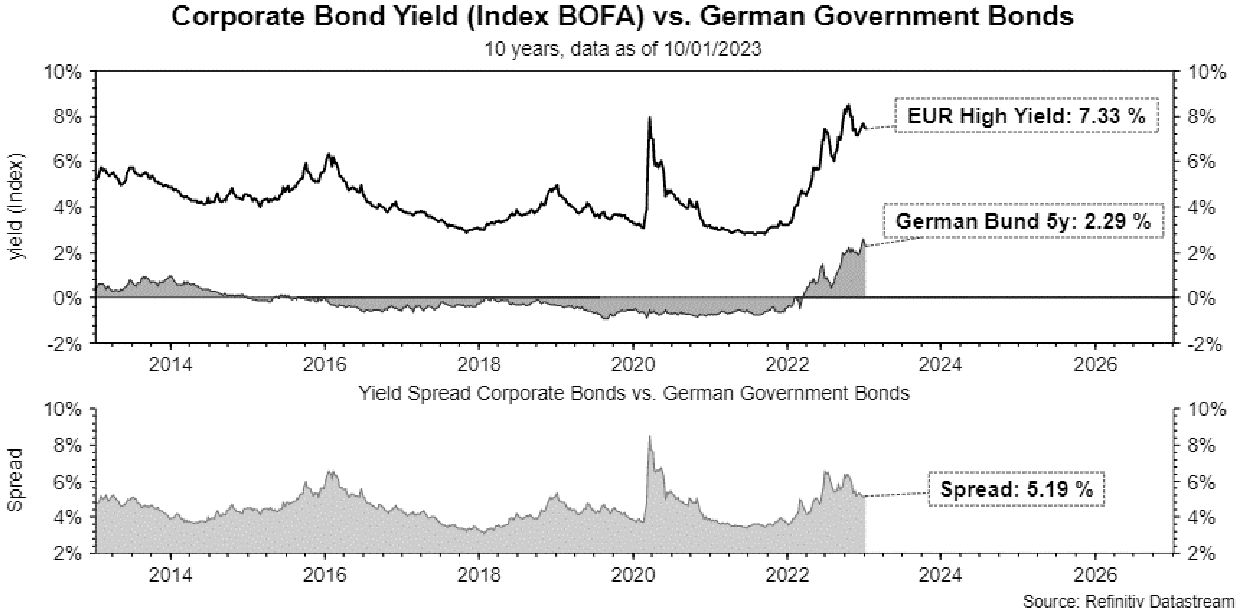
- The entry yield is currently at a higher level than in the past ten years.
- The yield differential to a German government bond (as a reference for the best possible credit rating in the Eurozone) is above 2%. The only time this spread was higher than this was in 2020 in the course of the Corona crisis.

After the rapid rise in yields in 2022, investment grade corporate bonds are currently offering entry yields above the level of the past ten years.

High-yield – maybe even more interesting?

The following chart shows the above comparison for the high-yield segment of European corporate bonds. Two remarks are in order at the outset:

- In the high yield segment, the default rate tends to be significantly higher than in the investment grade segment. This risk must be compensated by an accordingly higher yield
- Since the average maturity of bonds in the high yield segment tends to be 5Y (and thus shorter than in the investment grade segment), we also compare their yield to that of a 5Y German government bond



Chart, above: high-yield Eurozone corporate bond yield (BOFA indices) in comparison with the yield of 5Y (i.e. 5Y remaining time to maturity) German government bonds

Below: yield differential corporate bonds vs. German government bonds

Source: Refinitiv Datastream, 10Y, data as of 10 January 2023

Note: Past performance is not reliable indicator of future performance.

At first glance, we can see:

- At currently 7.3%, the yield in the high-yield segment is significantly higher than that in the investment grade segment
- The current yield is roughly at the level we experienced during the Corona sell-off
- The spread on German government bonds is over 5%. It has only been twice in this range or slightly higher the past ten years

If you look at the current historically high inflation rates in the Eurozone as a benchmark, it seems there is a chance that by investing in the high-yield segment one could achieve a return that could roughly compensate for inflation. And at the current level, this asset represents an investment opportunity that excels as alternative to the stock market, which has not been the case for many years.

What should the investor bear in mind when investing in corporate bond funds?

As with any investment, there are also corresponding risks in addition to possible return opportunities when investing in a corporate bond fund. There is a plethora of funds in this market segment. Investors should not be tempted to invest solely on the basis of return. Among other things, the following aspects should also be taken into account:

- In what credit rating segment does the selected fund invest?
- What is the economic environment like? Can we expect higher default rates (e.g. in the event of a recession)?
- How attractive is the selected market compared to other investment alternatives?

A corporate bond fund usually offers to categories of fund shares:

- **A-shares** (with regular, usually annual dividends) and
- **T-shares** (no dividends; long-term building of capital via automatic re-investment of the return)

This means that when selecting a fund, you can decide whether you want regular income in the form of dividends or not.

Conclusion

Corporate bond yields in both the investment grade and high-yield segments have risen significantly in recent months. This means that we are now at interesting entry levels again.

Investors are spoilt for choice: there are many corporate bond funds with different investment strategies and corresponding risks. Before investing, interested investors should therefore find out exactly whether the respective fund is suitable for their investment needs.

And one final piece of advice: the more aggressive (i.e. risky) the investment, the more important it is to pursue a strategy of broad diversification.

Further information and estimations by our experts on the subject of bond funds can be found in our current dossier **"Bonds reloaded"**.

Please note that an investment in securities also entails risks in addition to the opportunities described.

Johann Griener

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"