Corporate Bond Funds

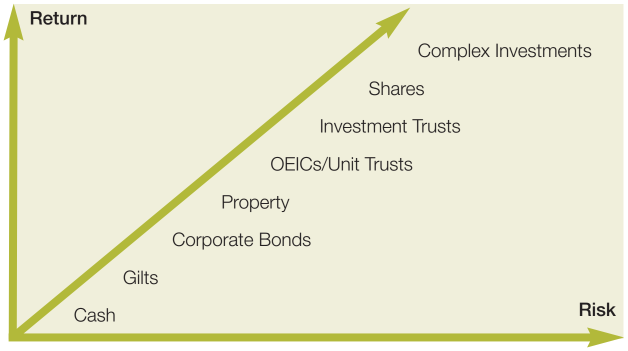
by Andy Parsons, Advice team manager

In the current economic climate, many investors are faced with a puzzling question. How can I generate an income from my investments when interest rates keep falling?

The answer may lie with an asset class that for many years was out of favour and often referred to as being very dull and boring – Corporate Bond Funds.

In the words of many a fund manager, opportunities and value within this asset class don't come along too often. It just so happens that over the last 6 months or so, they've come along like the proverbial buses.

It's worth reminding ourselves what a Corporate Bond actually is. A Corporate Bond is essentially an IOU from a company to an individual or corporate who has lent them money. In return for the loan, the investor will receive an amount of interest (known as the yield or dividend) from the company for the period of the loan's life. If held until the end of the loan's term, the amount should be repaid in full. A Corporate Bond Fund is simply a fund that invests in a basket of Corporate Bonds.



The chart above indicates the general level of risk associated with different asset classes. As you move up the scale diagonally left to right, the greater the potential risk to your investment. So there is a potential downside to corporate bonds: risk. A UK Government gilt is deemed to be risk-free as there is little or no chance of the Government defaulting on the interest payments. The same cannot be said of Corporate Bonds. With a company, there is always the possibility it may default on payments in times of severe financial hardship.

Therefore, with such potential risk, a company needs to offer a rate of interest in excess of that available from gilts to entice investors and to compensate for the higher level of risk being taken. However, given current market conditions and the wider concerns within the global economy, investors are quite rightly questioning whether any investment or asset class is safe.

So why the current media attraction to this asset class? Well, with potentially high returns on offer from Corporate Bond Funds, it is little wonder that investors are looking at this asset class as an alternative to cash and gilts. But how big is the risk, and do all Corporate Bond Funds carry the same degree of risk? That depends on the selection and quality of the underlying Corporate Bonds.

Investors often ask who actually issues the underlying Corporate Bonds and the answer is simply many of those companies listed on the main markets including Shell, BP, Unilever, Tesco, Centrica and all the main high street banks to name but a few. In addition, many smaller companies offer bonds and it is particularly here that you need to fully appreciate the risks involved.

Return

By nature of size, the smaller the company issuing a Corporate Bond, the greater the potential risk of default due to their underlying financial strength and capacity to survive severe financial hardship. Such a company will therefore need to offer a greater return to entice investors compared to a company that is deemed to be financially strong. That has always been the general rule. However, given the current economic predicament, many bonds have been offering what the experts consider to be once in a lifetime opportunities with coupons and yields in relation to gilts that have very rarely been seen before.

Examples of potential coupons on Corporate Bonds issued by three FTSE 100 companies can be seen below.

Company	Coupon	Year of maturity
Centrica	5.875%	2012
Tesco	6.625%	2010
HBOS	9.375%	2021

Whilst these bonds may look attractive in terms of coupon, you need to bear in mind that they may only be available to you through a fund as there is often a minimum investment level that places direct investment out of many investors' reach.

Ratings

All underlying investments held within a Corporate Bond Fund are classified by the ratings afforded to each individual company by the various ratings agencies. The main rating agencies are Standard & Poor's, Moody's and Fitch. Prior to direct investment, or investment via a Corporate Bond Fund, it's important to appreciate the rating attributed to the holdings.

The highest possible rating that can be attributed to a Corporate Bond is that of 'AAA' from Standard and Poor's or Fitch or 'Aaa' from Moody's. All Corporate Bonds with a rating between 'AAA/Aaa' down to a rating of 'BBB-/Baa3' are officially classified as 'Investment Grade'. All Corporate Bonds that rate from 'BB+/Ba1' and lower are classified as 'non-investment grade'. The lowest possible rating that can be attributed to a Corporate Bond is that of 'D' from Standard and Poor's or Fitch or 'C' from Moody's, all of which are classified as 'Junk'. The lower the rating attributed to an individual bond, the higher the potential risk of payment default and therefore the higher the yield on offer. More information on the ratings afforded to companies by the three main ratings agencies can be found on our website at www.share.com/riskratings.

Investment Opportunities

There is a wide variety of opportunities available within the Corporate Bond Fund market. You can find two of our favourite Corporate Bonds below. Full details of how we reach our views on investments can be found on our website at www.share.com/risk.

Conclusion

If interest rates continue to fall and you're looking for a return in excess of that offered by cash you could consider one of the most unloved asset classes of recent time – Corporate Bond Funds. Remember though, the value of your investments and the income from them can go down as well as up.

Invesco Perpetual Corporate Bond Inc Fund Managers: Paul Read & Paul Causer

0% initial charge see page 3

Risk rating: low | Fund size: £2,464m at 30 November 2008 | Yield: 7.21%

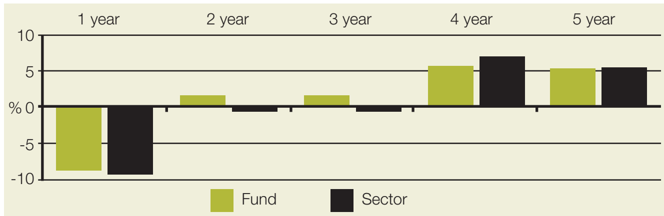
Aim: To achieve a high level of overall return, with relative security of capital; it invests primarily in fixed interest securities. In pursuing this objective, the Fund Managers may include investments that they consider appropriate which include transferable securities, money market instruments, warrants, collective investment schemes, deposits and other permitted investments and transactions.

Opinion: If you are looking for a strong yielding bond fund with robust decisive management this Fund may well be for you. Both of the Fund Managers, who have been at the helm since July 1995, are well respected and their comments and thoughts are regularly sought within the financial press and financial adviser arena. As the recent financial debacle has played out, this Fund has endeavoured to take advantage of the opportunities afforded by banks and other financial institutions as they attempt to redress their balance sheets. With the majority of banks underpinned by the Government, the attraction of high yields and a significantly reduced risk of default has been key to a number of their investment decisions.

As at 30 November 2008, 80.2% of the portfolio was invested in investment grade bonds as qualified by S&P.

Discrete quarter-end performance to 31 December 2008

	1 year	2 year	3 year	4 year	5 year
Fund	-8.5%	1.9%	1.6%	5.9%	5.5%
Sterling Corporate Bond	-9.1%	-0.4%	-0.5%	7.0%	5.6%



M&G Corporate Bond A Inc Fund Manager: Richard Woolnough

0% initial charge see page 3

Risk rating: low | Fund size: £1,300m at 30 November 2008 | Yield: 5.14%

Aim: To achieve a higher total return (through a combination of income and capital growth) from investment than would be obtainable in UK Government fixed interest securities (i.e.gilts) of similar maturities by investing in sterling denominated fixed and variable rate securities, including Corporate Bonds and debentures.

Opinion: M&G have long been respected for their bond funds and this Fund is a prime example of one of their flagship funds. Richard Woolnough has been at the helm of this fund since 2004 and has a proven track record of performance as seen in the table below.

As at 30 November 2008, 80.7% of the underlying portfolio was invested in investment grade assets. In order to help minimise risk, the Fund looks to limit the exposure to any underlying asset to no greater than 3% of the Fund's overall size.

Discrete quarter-end performance to 31 December 2008

	1 year	2 year	3 year	4 year	5 year
Fund	-1.2%	2.0%	0.1%	7.4%	5.8%
Sterling Corporate Bond	-9.1%	-0.4%	-0.5%	7.0%	5.6%