Cincinnati Asset Management

$25 Par Bonds – A Questionable Value Proposition
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There are many reasons that an investor may employ a professional bond manager. One of the most important considerations when working with a professional bond manager is its access to institutional trading desks and its ability to purchase bonds at a fair or attractive price. Many investors are aware that equities are exchange traded, which allows investors to easily buy or sell equity securities with relatively low transaction costs. Unlike equities, bonds are not exchange traded and are traded over the counter, where relationships with dealers can have a meaningful impact on the prices you receive for buying and selling these securities. This opacity can result in meaningful transaction costs for the investor. Retail investors that manage their own bond portfolios often must pay a "mark-up" when they transact in these securities at their brokerage house. In addition to this increase in cost to the investor, the brokerage firm may only have a limited selection of bonds in their inventory from which to choose, resulting in a situation where the investor experiences higher costs and is presented with a narrow list of securities to choose from. In contrast, a professional manager will typically have relationships with dozens of firms that transact in bonds and many thousands of different bond issues from which to choose. Due to advances in electronic trading, most professional managers will also have the ability to engage in transactions with hundreds of other institutional managers and professional investors in what is referred to as, "all-to-all trading," which serves to provide better execution for a professional manager.

Currently, there's a product that is marketed to advisors and retail investors that typically offers less relative value compared to what the investor and her advisor can receive elsewhere in the corporate bond market. These securities are referred to as "baby bonds," and they are marketed through the same channel as preferred stock securities. An advantage of these bonds is that the minimum denomination that one can invest is smaller than the typical corporate bond (i.e., $25 minimum versus $1,000 minimum), hence the term "baby bond." The problem with these types of issues is that the investor may be sacrificing compensation, liquidity and covenant protection, compared to what the investor could find elsewhere within the corporate bond market. The risks and costs incurred by investing in these securities seem greater than the marginal benefit of being able trade in smaller dollar increments.

The following two examples provide a good illustration of how bonds that are marketed to retail investors usually offer less value versus bonds that are more widely traded by professional managers and institutional investors.

Case Study #1

On July 25th, 2018, AT&T announced a retail-oriented bond deal that matures on 08/01/2067. This AT&T deal is the type of primary bond deal where an investor could participate in the new issue process through their financial advisor, whereas the individual investor would have no such access to institutional deals unless they employed a professional bond manager. It should be noted that institutional deals make up over 99% of all primary issuance. There are several features that make this bond more marketable to retail investors.

- The bond trades in increments of $25, whereas the minimum increment for the typical institutional bond deal is $1,000. This makes it more accessible to the retail investor. However, due to several factors, this bond will lack liquidity and be ignored by institutional investors.
- The bond has a call feature. Though the bond matures in 49 years, it can be called any time after the first five years. If interest rates were to go down at some point after the first five years, then AT&T would have an incentive to call this bond and re-issue debt with a lower interest rate. A call feature is disadvantageous to an investor in this case because the investor loses out on her ability to receive higher interest payments, if interest rates go down in the future. This type of call feature would typically be negotiated away by institutional investors as part of the new issue process.

- The bond also has a call feature that allows it to be called at any time upon a "Tax Event." This covenant language is unacceptable to a professional bond manager. It gives the issuer far too much allowance to redeem the bonds.
- This retail oriented bond was poorly priced relative to the rest of the capital structure.
  - The retail bond was priced at par with a coupon of 5.625% and a yield of 5.625%.
  - On the very same day this retail bond was issued, a professional bond manager could have purchased an AT&T bond with a yield to maturity of 5.683%, maturing 10 years earlier than the retail bond issue. The investor in the retail bond is not receiving extra compensation for an additional 10+ years of maturity, and is also not receiving additional compensation for the call features or for the weaker covenant package. Because of these factors, the institutional bond maturing in the year 2057 is a much better value than the retail bond maturing in 2067. This asymmetry in information and lack of access, places the retail investor in a disadvantaged situation to make informed decisions in the bond market. In this example, the professional bond manager will choose the 2057 institutional bond in almost every scenario.

Date: July 25, 2018	**Retail Bond**	**Institutional Bond**
Issue	T 5.625, 08/01/2067	**T 5.700, 03/01/2057**
Years to Maturity	49	**38.6**
Issue Size ($MM)	750	**1,000**
Coupon	5.625%	**5.700%**
Yield to Maturity	5.625%	**5.683%**
Price	100	**100.259**
Call Feature	Yes - after 5 years	**No**
Covenant Strength	Weak	**Standard**

<u>Case Study #2</u>

On September 6, 2018, QVC Inc. announced a retail-oriented bond deal that matures on 9/13/67. On that very same day, investors could have purchased the QVC bonds maturing in 2043 at a higher yield than the 2067 retail notes. Additionally, the 2043 bonds were trading at a nearly six point discount to par, so investors would not have had to invest as much cash as they would have for the retail bonds. In this case, the institutional bond was a far superior value than its retail counterpart, since it provided more yield, shorter term to maturity and a discounted price.

Date: September 6, 2018	**Retail Bond**	**Institutional Bond**
Issue	QVCN 6.375, 09/13/67	**QVCN 5.950, 03/15/43**
Years to Maturity	49	**24.5**
Issue Size ($MM)	225	**300**
Coupon	6.375%	**5.950%**
Yield to Maturity	6.375%	**6.424%**
Price	100	**94.189**
Call Feature	Yes - after 5 years	**No**
Covenant Strength	Standard	**Standard**

The bond market can be difficult to navigate, and because of this, a professional manager can help to mitigate many of the risks that investors might face in the corporate credit markets. As we discussed in this paper, a professional manager can be particularly helpful in ensuring that an investor is receiving appropriate value and execution on their investments within the corporate bond markets.

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