High Risk In Corporate Bonds

Everyone involved in financial markets has an opinion on whether stocks are overvalued, as well they should. Experience teaches us regression to the mean is a powerful force, and we all understand paying too much for an asset is not a good idea. Whether more money has been lost over the years by paying too much for the highfliers or by taking fliers at falling knives, a wince-worthy metaphor if I do say so myself, is a subject for further discussion.

Somehow, though, corporate bonds tend to get left out of this conversation, which is unfortunate because investment-grade bonds have a great deal of interest rate risk at the moment and high-yield bonds have lost what the Graham & Dodd crowd might call the margin of safety. As much of the stock market rally since June 2012, the time when QE3 started to get priced into the market, has been driven by a rally in corporate bonds, the bond market's risks should be as much of a concern as whether the NASDAQ is going to pull off Faceplant 2.0 on our watch.

Two Measures Of Risk

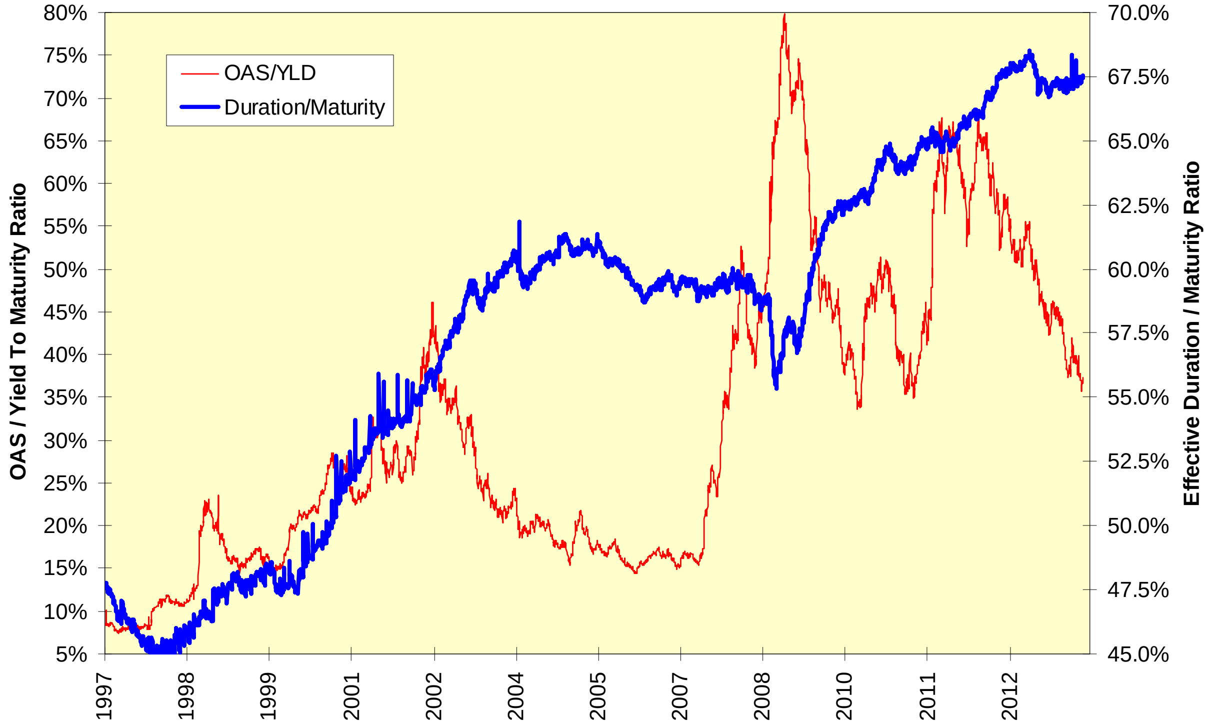
We can construct two ratios to measure interest rate risk and credit risk, respectively, on a normalized basis. The first is the ratio of effective duration to maturity. As yields fall, the effective duration of a bond rises toward its maturity; the duration of a zero-coupon bond is its maturity. This measure has reached its post-1997 high of 68.3% in April 2013 for the Merrill Lynch investment-grade index and was at 67.5% after last Thursday's stock market plunge. The iShares iBOXX Investment Grade Corporate Bond ETF (LQD) is trading one step over a zero-coupon bond; make that the 115 basis points of its option-adjusted spread (OAS) over the Treasury yield curve. As the investment-grade indeed has weighted-average maturity of ten years and real interest rates at that maturity are 0.5% you are lending corporate borrowers money for ten years and getting a -0.50% real dollar return once we strip expected inflation out of the OAS. Locking a loss in makes sense only if you are buying insurance against a bigger loss.

The second measure is the percentage of a bond's yield represented by its OAS. The maximum ratio here is 100%; this would represent a Treasury yield of 0% with the bond's entire yield representing credit risk. This measure was at 86.6% in June 2013 and declined all the way to 60.6% on April 4, 2014. For those of you keeping score, this measure was as low as 32.0% in June 2007 before the financial crisis hit and sent to 97.6% in December 2008.

High-yield bonds, accessible via ETFs such as the iShares iBOXX High-Yield Corporate Bond ETF (HYG), have an OAS of 377 basis points. Their weighted-average maturity is 6.6 years; real interest rates are near 0% at that maturity. Once again, you can lend to low-grade credits for a real return of less than 1.9% once inflation is stripped out of the OAS. This sounds a little pricey.

Maps of the two risk ratios for investment-grade and high-yield bonds, respectively, are shown below.

Investment-Grade Bonds At High Rate Risk
And Declining Absolute Credit Risk



High-Yield Bonds At Decreasingly High Rate Risk
And Declining Absolute Credit Risk