

**PaineWebber®**

Investor's Guide  
to Corporate Bonds

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CORPORATE  
BONDS

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## INTRODUCTION TO CORPORATE BONDS

A corporate bond is simply a debt security, or IOU between a lender (investor) and a borrower (issuer). Typically issued by corporations, or other large organizations, corporate bonds are one of the more popular ways for a company to raise capital and conduct business (e.g., for the purchase of new plant and equipment, or the refinancing of maturing debt).

In its most basic form, a bond is a promise by the issuer to pay back a fixed amount of money (principal) to the investor at a specified date in the future (maturity). The investor is compensated for lending their money by receiving interest payments either periodically throughout the life of the bond, or as one lump sum on the maturity date. Once a corporation issues bonds, the investor becomes a creditor of the issuing corporation.

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## CLASSIFICATION OF CORPORATE BONDS

Most corporate bonds are classified into three main categories: utility bonds, industrial bonds, and bank and finance company bonds. Utility bonds include those issued by telephone or communication companies, as well as electric, gas and water organizations. Industrials are composed of debt securities issued by manufacturing, mining, retailers and other service-related companies. Generally, investors in the past have perceived utilities as having lower yields and associated risk relative to bank and finance bonds, but this may not always be the case.

Corporate bonds can either be securitized by the collateral of real property or assets, or backed by the general creditworthiness of the company. The specific creditworthiness of a company is dependent on, among other things, its financial resources, standing relative to the competition, and the environment in

which the company operates. Exhibit 1 indicates the ratings that can be assigned by the rating services to both investment grade (Aaa/AAA–Baa/BBB) and below investment grade issues (Ba/BB–D), which will be described later.

<b>Exhibit 1</b>											
	<b>Investment Grade</b>					:	<b>Below Investment Grade</b>				
<b>Moody's</b>	Aaa	Aa	A	Baa		:	Ba	B	Caa	Ca	C
<b>S&amp;P</b>	AAA	AA	A	BBB		:	BB	B	CCC	CC	C D

*Note: Moody's applies numerical modifiers, 1, 2, and 3 in each generic rating classification from Aa to B. Modifier 1 indicates that the company ranks in the higher end of its generic rating category; modifier 2 refers to a mid-range ranking; and modifier 3 indicates the lower end of its generic rating category. On the other hand, S&P modifies its ratings from AA to CCC by the addition of a plus (+) or minus (-) sign within major categories.*

Bonds rated below investment grade by credit rating services are called high yield bonds. Originally, companies that did not qualify for an investment grade rating status were limited to raising funds either through bank debt or private placement debt issuance. However, in 1977 the high yield market expanded as issuers, seeking alternative sources of financing, tapped the traditional debt market by offering securities with higher returns than investment grade debt instruments in exchange for above average credit default risk. Part of the appeal of high yield securities comes from the possibility that company fundamentals may improve, which could lead to a credit upgrade.

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## TYPES OF CORPORATE BONDS

This guide will primarily discuss the common characteristics of investment grade corporate bonds. There are a variety of structures under the corporate umbrella that have distinctive properties.

### *Secured Bonds:*

- 1) **Collateralized Trust Bonds** — These bonds are backed by securities of another corporation, usually stock. Corporations issuing Collateralized Trust Bonds usually pledge the stock of a subsidiary.
- 2) **Equipment Trust Certificates** — These are corporate bonds backed by specific equipment, such as railroad cars, ships or airplanes. Equipment Trust Certificates are generally issued by transportation companies, and are considered to be secured investments. Generally, the principal amount of the bonds will be retired at a faster pace than the equipment is depreciated. This ensures that the equipment will be worth more than the outstanding principal of the bond in the event of a default.
- 3) **Mortgage Bonds** — These bonds are secured by a pledge of real property in which bondholders have a lien or mortgage on the property. Corporations may issue first and second mortgage bonds secured by the same property. However, first mortgage bondholders have senior status to the lien on the property over and above the second mortgage bondholders, who have junior status. Once again, the principal amount of the bonds outstanding will generally be less than the value of the pledged property.

### *Unsecured Bonds:*

- 1) **Debentures** — Corporate bonds not backed by any pledged property or asset, but rather, backed only by the good faith of the issuing corporation, are referred to as debentures. In the event of a default, a debenture holder's claim would be after that of a secured bondholder's claim.

**2) Subordinated Debentures** — These are unsecured bonds that hold a junior status to debentures. In the event of a default, subordinated debenture holders would rank behind general creditors, mortgage bondholders and debenture holders with claims on assets.

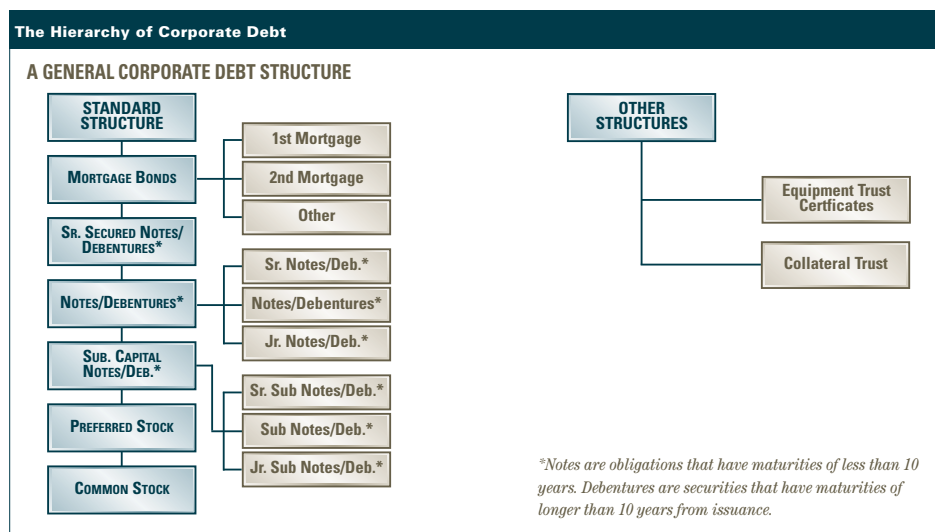
**3) Medium Term Notes (MTNs)** — Corporate issuing programs established to permit companies to issue debt securities continuously or from time to time, at the discretion of the issuer, are called medium term notes. MTNs generally have maturities ranging from nine months to 30 years, are interest bearing, and usually pay interest semiannually.

**4) Multi - Coupon Callable Step Rate Bonds** — These are notes with fixed maturity dates and limited call protection. The stated coupon on these securities will usually increase or decrease annually, provided the issuing company does not redeem the issue.

**5) Sinking Fund Debentures** — Bonds with provisions that set aside a certain amount of money each year to retire a portion of the debt obligation are referred to as sinking fund debentures. Sinking fund provisions can be mandatory or optional on the part of the issuer.

**6) Zero Coupon** — These are bonds issued at a substantial discount to their par value and pay no interest until they mature. Instead, the interest accrues over the life of the security. Since they are Original Issue Discount (OID) bonds, corporate zeros are well-suited for a tax-advantaged account (IRA, Keogh, etc.), because taxable accounts are subject to income tax on the annual accrued interest regardless of whether any funds are received.

**7) Floating Rate or Variable Notes** — There can be many variations of bonds in this category. Generally, floating rate and variable rate notes have coupons that can change periodically with fluctuations in a specified index or benchmark.



Within a corporation's capital structure, certain securities are senior to others and correspondingly have claims on assets and earnings prior to other bonds. For example, in order of decreasing seniority, bonds can be broken down into either senior secured (secured by assets of a corporation, such as property and equipment), senior securities, debentures, or subordinated debentures. Subordinated debentures are unique in that they are junior to other existing debt, but senior to preferred and common securities of a company. Investors should strongly consider the status of a bond within a firm's capital structure when making investment decisions. However, in large corporations with many subsidiaries, the order of seniority might not always be clear. Such can be the case for holding companies.

A holding company is not an owner of firm specific fixed assets or real property, rather, it is the owner of operating subsidiaries and their respective assets. This is an important distinction when attempting to determine the order of seniority between a bond issued by a holding company versus one issued by an operating subsidiary. With the exception of bank debt (which typically has first claim to assets), obligations issued by an operating subsidiary company are senior to, and have a claim on the assets of the subsidiary, before bondholders at the holding company level. Thus, it is possible that the senior notes of a holding company can be structurally subordinate to the debt issued at the operating subsidiary.

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## CALL FEATURES OF CORPORATE BONDS

In many cases, there are provisions that allow the issuer of corporate bonds to redeem (call) the security prior to its final maturity date. Therefore, it is especially important for an investor who purchases corporate bonds to be aware of any call features that

could affect realized returns. Typically, these provisions are exercised in a declining rate environment when it is cost effective for the issuer to retire part, or all, of a higher coupon debt obligation and replace it with a lower coupon debt obligation. To compensate investors for this risk, callable bonds usually carry higher yields relative to non-callable bonds. Some of the most common methods of redeeming corporate bonds include call provisions, sinking funds and special redemptions.

- **Call Provision** — Issuers can retain the right to retire a corporate bond through a call provision. The terms, however, differ for each issue and should be evaluated on an individual basis. If the call price is at a premium, it usually declines to par over a specified period of time.
- **Sinking Fund** — As previously mentioned, sinking fund provisions can require, or give the issuer the option, that a certain percentage of the total issue be retired over a specified period of time. The primary difference between a sinking fund provision and a call feature is that callable bonds can be retired all at once whereas only a percentage of the total sinking fund debt obligation is retired, usually on a pro rata basis. In addition, the issuer conducts a call on a voluntary basis, while a sinking fund can be voluntary or mandatory and must conform to a set schedule.
- **Special Redemptions** — There are certain conditions under which an issuer can redeem bonds. While these circumstances can vary from issue to issue, investors should be aware of the events that can trigger such a redemption by reviewing the bond's prospectus.

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## HOW ARE CORPORATE BONDS TRADED?

The par value, or principal amount of a corporate

bond is usually \$1,000. Trades are executed in multiples of this amount either on the New York Stock Exchange (NYSE), or through the Over-the-Counter (OTC) market.

Typically, if bonds are traded on an exchange, orders for these bonds may be placed through an Automated Bond System (ABS). For orders of nine bonds or less, the trade must be executed on the corresponding exchange.

Many corporate bonds that trade on an exchange are also quoted in the financial sections of daily newspapers. For instance, *The Wall Street Journal* provides a description of the bond (e.g., issuer, coupon and maturity date), the current yield (a ratio of the bond's coupon rate to the current market price), the previous day's number of sales, the price of the bond at the end of the trading session, and the net change from the previous session's close (see Table 1).

**Table 1**

Bond	Current Yield	Volume	Close	Net Change
ATT 8 $\frac{1}{8}$ 24	8.0	107*	102	- $\frac{1}{8}$

\* Volume in thousands of dollars

Bonds that are not traded on an exchange are sold in the OTC market. The OTC market is a group of large dealer firms. They make wholesale markets in large numbers of bond issues among other wholesalers and broker-dealer firms. This means that individual "dealers" purchase bonds for their own trading account and then offer them for resale. Even if a bond is listed on an exchange, larger transactions are often completed in the OTC market.

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## HOW ARE CORPORATE BONDS QUOTED?

Corporate bonds are typically quoted as a percentage of their par value. For instance, a quote of 97 $\frac{1}{2}$

means that the bond is selling for \$975 per \$1,000 par amount. A quote of 101½ means that the bond is trading at \$1,015 per \$1,000 par value.

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## WHAT IS A PREMIUM OR DISCOUNT?

As mentioned previously, the par value of a corporate bond is usually \$1,000 per bond. Securities trading above their par value (e.g., \$1,015) are said to be trading at a premium. On the other hand, securities that are trading at a price below their par value (e.g., \$975) are said to be trading at a discount. Typically, changes in the level of interest rates after a bond's original issue will cause the market value of the corporate bond to change.

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## FACTORS THAT INFLUENCE CORPORATE BONDS

It is important to keep in mind that the corporate bond market is both dynamic and diverse. What appeals to one investor may not always be considered desirable by another. Therefore, when considering a purchase of a corporate bond, it is important to understand and consider some of the factors that influence them.

- **Yield** — The yield of a bond is critical because it affords investors the ability to compare the relative value of a variety of investment opportunities. One measure of yield, yield-to-maturity, places a value on the return of a bond if held to maturity. It is important to note that the yield and price of a bond move in opposite directions. For example, if interest rates rise, the price of the bond will fall. The yield of a bond fluctuates with changes in the overall level of interest rates. Review the following example:

Assume that you purchased a corporate bond with a 7% interest rate and a 20-year maturity for \$1,000. As long as you continue to hold this security, you would realize \$70 in income annually. But

what if three years after you purchased it, interest rates rise such that new corporate bonds are being issued at a yield to maturity of 8%? In order for the bond you own to be attractive to another buyer, should you want to sell it, the price would be adjusted lower so that it also yields 8%. Thus, the yield-to-maturity for the bond has increased. Conversely, if new corporate bonds are being brought to market at a 6% yield, the market value for your bond would be adjusted higher. In other words, a potential purchaser of the bond you own would pay a higher price in order to receive the \$70 of annual income, rather than purchase a new issue at its par value and receive \$60 annually. As a result, the price of the bond has increased while its related yield to maturity has declined.

While this example somewhat simplifies the concept of yield as it relates to the market value of a bond, it is important to remember that yield-to-maturity plays a critical role in evaluating the value of a bond relative to other investments.

- **Credit Rating** — As previously mentioned, the credit quality of a corporate bond will typically influence the yield at which a bond will trade. This is because the market perceives a difference in the risk profile of corporate debt obligations that have lower credit ratings. For example, a AAA-rated corporate bond will have a lower yield because there is less perceived risk than an issue that is rated BBB. Investors seeking yield may be willing to accept more risk in order to achieve a higher return. Additionally, if the credit rating of a corporate bond is downgraded, the market value of the security could be adversely affected. The reverse can also be true if a bond is upgraded in credit quality.
- **Redemption Features** — If a bond has an early redemption feature, the market value of the bond

may be affected, depending on when the redemption becomes effective and at what price the security can be redeemed. For instance, if a bond is trading at a premium, and has the possibility of being redeemed at par, a potential investor should take into consideration the bond's yield to its call date, or yield-to-call, in order to evaluate the investment properly.

Redemption features tend to limit the potential for price appreciation of a bond, especially if it is trading at or near its call price. This is because investors are generally not willing to pay a premium to the respective call price if the bond can be redeemed before they have had time to recapture the premium that was paid.

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## THE ADVANTAGES OF CORPORATE BONDS

Corporate bonds offer investors:

- **Attractive Yields** — Corporate bonds generally offer higher yields when compared to similar maturing Treasury securities. Typically, lower credit ratings translate into higher bond yields.
- **Diversity** — Corporate bonds are available in a wide selection of structures, coupon rates, maturities, and issuers. Investors can choose to diversify their portfolio holdings and in doing so, bear less exposure to any one market or structure.
- **Capital Appreciation Potential** — Corporate bonds offer the potential for capital appreciation since, all else remaining equal, their prices fluctuate with the level of interest rates. For instance, in a declining rate environment, a corporate bond's price will generally trend higher, thereby enhancing the holder's total return.
- **Marketability** — PaineWebber is an active participant in the secondary market for corporate bonds.

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## RISKS TO BE CONSIDERED WHEN INVESTING IN CORPORATE BONDS

Corporate bonds bear exposure to certain risks and may therefore be unsuitable for certain investors.

A few of these risks include:

- **Interest Rate Risk** — As with any fixed-income investment, corporate bonds are subject to market value fluctuations because interest rates and bond prices move inversely. When interest rates rise (fall), the price of a bond falls (rises). Therefore, if sold prior to maturity, the price received for an issue may be more or less than the original purchase price.
- **Reinvestment Risk** — Since most corporate issues pay interest semiannually, the reinvestment of coupon payments over the life of the bond can have a major impact on the bond's total return. If interest rates decline, investors may be faced with reinvestment at lower prevailing rates.
- **Credit/Event Risk** — Corporate bond investments are also subject to event risk and changes in credit quality. Companies can experience increased competition, takeovers and other economic situations that may have adverse effects on the market value of their securities.

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## INVESTING IN CORPORATE BONDS AT PAINWEBBER

PaineWebber acts as an underwriter and a market maker for corporate bonds. Additionally, PaineWebber maintains an active secondary market in corporates.

Ask your PaineWebber Financial Advisor for additional information about corporate bonds to determine if they are suitable to help meet your investment objectives.



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