Bonds at a discount: The taxable bond market

EAGLE Asset Management

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Interest rates remained near all-time lows for almost two years following the historic monetary policy response to the COVID-19 pandemic. During this period, corporations took advantage of favorable borrowing conditions by issuing debt with low coupon payments. When interest rates began to rise throughout 2022 and 2023, market yields increased, and the low coupon-paying bonds started trading at a discount. This caused mark-to-market losses for investors who held these bonds, but it also presented an opportunity for higher prospective forward-looking returns through increased yield potential.

When investing in bonds, the income from coupon payments is a significant component of the return. The other critical aspect is the amortization of a bond's price relative to the par value that will be returned at the bond's maturity (assuming no default occurs). This difference between purchase price and par value can create opportunities for gain: Bonds can trade at a discount, below face value, when their coupon is less than the market required yield, and bonds can trade at a premium, above face value, when their coupon is greater than the market required yield.

As a bond approaches maturity, its discount or premium is factored into its total return. Although these adjustments may not be immediately recognized as income (for bonds at a discount) or losses (for bonds at a premium), they are accounted for in the total return, because these differences are reflected in a bond's market value.

Active management in separately managed accounts may allow investors to realize returns by selling bonds before they reach maturity. Bonds that are bought at a discount may reduce "current yield," which is the coupon/market value of a bond, but that is a less relevant measurement for active managers. "Yield to maturity," which considers the amortization of a bond premium/discount, and "yield to worst," which considers any options that could shorten a bond's maturity and accelerate its amortization, are more relevant for total return, which should be an investor's ultimate focus.

Consider a theoretical bond with a 4.0% coupon and five years to maturity. Since the coupon is below the prevailing market yield, the bond should trade at a discount: In order to offer the market yield for a bond of its characteristics, it would be priced at $90. The bond's below-market coupon means that a substantial portion of the bond's total return each year comes from principal accumulation occurring as it gets closer to maturity, known as "pull to par." (Note that this assumes no change in the prevailing market yield, and bonds generally become less sensitive to rate changes as they approach maturity.)

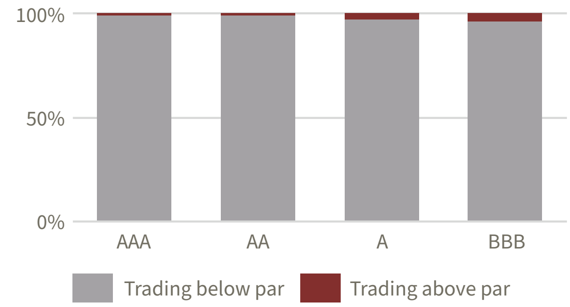
Year	0	1	2	3	4	5
Coupon		$4.00	$4.00	$4.00	$4.00	$4.00
Principal Gain		$1.76	$1.87	$1.99	$2.12	$2.26
Total Return		$5.76	$5.87	$5.99	$6.12	$6.26
Total Return (%)		6.40%	6.40%	6.40%	6.40%	6.40%
Price of Bond	$90	$92	$94	$96	$98	$100

Source: Eagle Asset Management, as of 10/23/23

It's important to highlight that the yields for specific bonds are determined by the market and based on various bond characteristics that include quality, duration, coupon, and reinvestment options. In a given market environment, the only way to change a portfolio's yield profile is to adjust the risks related to these characteristics. Increased yield comes from taking on higher risks in the portfolio, and reduced risk results in lower yield potential.

Current Market Environment

Many debtors issued debt with longer maturities during the low-interest-rate environment. Rising rates have led to a significant amount of this taxable debt trading at a discount. The chart below shows the market value of bonds in the Bloomberg U.S. Aggregate Total Return Value Index that were trading below par and above par as of Oct. 23, 2023, categorized by quality.



Source: Bloomberg, data as of 10/23/23

Risks associated with Fixed Income investing:

Many investors consider bonds to be “risk free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

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Definitions

A bond’s current yield is calculated by dividing its coupon payments (and other annual income) by its current price. This represents the theoretical return that could be expected by an investor purchasing the bond and holding it for a year. However, current yield calculations ignore the bond’s face value, and they do not represent the actual return that an investor could receive by holding the bond to maturity.

Duration incorporates a bond’s yield, coupon, final maturity, and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Mark to market is a method of measuring the fair value of assets, liabilities, or other accounts that can fluctuate over time. Mark to market strives to provide a realistic appraisal of a company or institution's current financial circumstances based on current market conditions. During volatile markets, however, mark-to-market measurements may not accurately represent an asset's true value in an otherwise orderly market.

Call options are financial contracts that give the buyer of the option the right, but not the obligation, to buy a stock, bond, commodity, or other instrument – known as the underlying asset – at a specified price (the "strike price") within a specific time period (the expiration or time to maturity). The buyer profits when the underlying asset increases in price.

Callable or redeemable bonds are bonds that can be redeemed or paid off by the issuer prior to the bonds' maturity date. When an issuer calls its bonds, it pays investors the call price (usually the face value of the bonds) together with accrued interest to date and, at that point, stops making interest payments.

Par-traded bonds have a price that matches their face value, which is the amount they will pay at maturity. When bonds are first issued, their value is at "par." When bonds trade in the secondary market, before their maturity date, their value may change in response to current interest rates. If their "coupon," or interest payment, is higher than current rates, they may sell at a premium to their par value. If their coupon is lower than current rates, they may sell at discount, or a price below par.

A bond's term to maturity is the period of time during which the investor in the bond will receive interest payments on the investment. When the bond reaches maturity the principal is repaid.

Total return, when measuring performance, is the actual rate of return of an investment or a pool of investments over a given period of time. Total return includes interest, capital gains, dividends, and distributions realized over the specified period. Total return accounts for two categories of return: income including interest paid by fixed-income investments, distributions, or dividends and capital appreciation, representing the change in the market price of an asset.

Yield to maturity is the total rate of return that will have been earned by a bond when it makes all interest payments and repays the original principal.

Yield to worst is a measure of the lowest possible yield that can be received on a bond with an early retirement provision. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures. The yield to worst metric is used to evaluate the worst-case scenario for yield at the earliest allowable retirement date. It is always less than yield to maturity because it represents a return for a shortened investment period.

Indices

The Bloomberg U.S. Aggregate Total Return Value Index is a broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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