UWEALTH

U Wealth : Your partner in mastering financial instruments.

GUIDE TO UNDERSTANDING ASSET CLASSES : NON-INVESTMENT GRADE BONDS

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

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FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk – but the higher, too, the opportunities for returns.

WHAT IS FIXED INCOME?

Fixed income instruments are financial investments where the issuer is obliged to make payments on a predetermined schedule.

These debt obligations do not represent any ownership in the company/institution of the issuer. For example, the borrower pays interest on a 'vanilla bond' at periodic intervals and eventually pays back the investment amount at a specified maturity date.

Fixed income instruments serve investment objectives that target the generation of steady cash flows and/or the preservation of capital. Examples are bonds and convertibles.

> For a general introduction to fixed income investing, please consult the separately available document on fixed income / investment grade bonds. This document focuses on the specifics and risks of investing into non-investment grade/high yield bonds.

A CLOSER LOOK AT NON-INVESTMENT GRADE/HIGH YIELD BONDS

BOND RANKINGS

Non-financial issuers

- Bonds have different claim levels in case the issuer defaults.
- The claim level determines how much money investors could possibly recover from their investment.
- Thus, the higher the claim level, the more secure is the bond (and the less interest is paid to the investor).

Risk level	Ranking	Explanation
Lower risk	**Senior secured bonds**	Debt obligations that are paid before any other debt liability. These bonds have specific pledges on the company's assets.
	Senior unsecured bonds	Debt obligations paid with priority before subordinated bonds.
Non-financials	**Subordinated bonds**	Bonds with a lower ranking than senior bonds. Only the remaining cash flow after satisfaction of the senior obligations is available to pay subordinated bonds. However, subordinated bonds are still senior to equity. Normally, most companies can afford to pay their subordinated debt. But in the case of distress, the debt can lose substantial market value.
	Hybrid securities	A security that contains multiple components, most frequently debt and equity. They pay a predictable rate of return or dividend until a certain date. For example, convertible bonds and contingent capital in banks.
Higher risk	**Ordinary shares**	Shares that entitle their holders to dividends that vary in amount and may even be missed, depending on the fortunes of the company. For example, equity.

BOND RANKINGS

Financial issuers

- The claims on issuers that are financial institutions are regulated separately [1] from those of non-financial institutions.
- The main difference is that subordinated bonds of financial institutions have several sub-categories that specifically detail claims.

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(1) Banks and other qualifying investment firms established or holding branches within the EU are required to issue minimum levels of specifically identified capital (titled "Subordinated Eligible Liabilities" or SELs) containing clauses identifying they can be subject to temporary or permanent cancellation of either coupon and permanent write down of capital (and in some cases convertibility to equity) to support an investor led bail. These features are triggered independently at government mandated thresholds, to ensure a "managed wind-down" minimising the risk to depositors or contagion to the wider financial system.

BOND RATINGS (1/2)

Creditworthiness is measured in ratings. There are three major companies that provide the framework and evaluate and publish debt obligation ratings: Moody's, Fitch, and Standard & Poor's. The ratings provide an important source of information about the quality of the investment.

The aim of the rating is to measure consistently the credit risk associated with investing in a specific company, institution, instrument, or market.

Ratings are a measure of the issuer's ability and willingness to repay debt. It is not, in any case, a recommendation to buy/sell/hold any investment.

> High-yield bonds refer to bonds that are generally below investment grade (below BBB- or Baa3 by established credit rating agencies) or are unrated. In general, the denomination 'high-yield' is equivalent to a 'speculative', 'non-investment-grade', or 'junk' rating.

All ratings are divided into two broad categories: investment grade and non-investment (speculative) grade. For details, see the next page.

BOND RATINGS (2/2)

Bond rating	Moody's	Standard & Poor's	Fitch Ratings	Credit rating definition
Investment grade	Aaa	AAA	AAA	Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
	Aa1	AA+	AA+	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	
Non-Investment grade (high-yield)	Ba1	BB+	BB+	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	Obligations rated B are considered speculative and are subject to high credit risk.
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
	Caa2	CCC	CCC	
	Caa3	CCC-	CCC-	
	Ca	CC	CC	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
		C	C	
	C	D	D	Obligations rated C are the lowest-rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.
	Unrated	Unrated	Unrated	

DEFAULT RATES

Moody's: Global default rates by alphanumeric rating (in %), 1983–2021

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Worst 5-Year cumulative default rate period since 1970	Year *
Investment Grade	0.08	0.22	0.40	0.61	0.84	1.09	1.33	1.57	1.81	2.05	2.30	1986
Aaa	0.00	0.01	0.01	0.04	0.06	0.09	0.12	0.13	0.13	0.13	2.25	1983
Aa1	0.00	0.00	0.00	0.05	0.09	0.13	0.13	0.13	0.16	0.20		
Aa2	0.00	0.01	0.10	0.22	0.33	0.40	0.49	0.58	0.69	0.82	1.71	1984
Aa3	0.04	0.11	0.16	0.24	0.37	0.49	0.62	0.73	0.82	0.88		
A1	0.06	0.18	0.37	0.56	0.75	0.93	1.08	1.22	1.34	1.49		
A2	0.04	0.14	0.29	0.47	0.68	0.98	1.31	1.63	1.95	2.27	2.27	1985
A3	0.05	0.16	0.34	0.51	0.76	0.99	1.26	1.56	1.86	2.12		
Baa1	0.10	0.27	047	0.68	0.88	1.12	1.36	1.58	1.84	2.13		
Baa2	0.14	0.34	0.58	0.89	1.19	1.50	1.84	2.17	2.52	2.89	5.14	1986
Baa3	0.22	0.55	0.9	1.48	2.06	2.66	3.16	3.71	4.26	4.79		
Non-Investment Grade	4.11	8.33	12.33	15.91	19.03	21.70	24.00	26.03	27.86	29.50	30.81	1989
Ba1	0.41	1.34	2.43	3.50	4.54	5.58	6.39	7.08	7.75	8.50		
Ba2	0.66	1.77	3.05	4.37	5.71	6.84	7.95	9.16	10.51	11.87	23.85	1987
Ba3	1.26	3.52	6.21	9.19	11.71	14.09	16.39	18.50	20.40	22.29		
B1	1.89	5.07	8.55	11.89	15.20	18.19	21.09	23.70	25.94	27.76		
B2	2.92	7.45	12.09	16.33	20.03	23.37	26.12	28.31	30.54	32.70	38.83	1988
B3	4.54	10.12	15.89	20.96	25.39	29.20	32.49	35.59	38.24	40.41		
Caa	7.41	14.49	20.68	26.15	31.12	35.37	38.85	41.98	44.92	47.44	81.25	1970
Ca-C	33.15	45.31	53.78	60.43	63.54	64.63	66.65	68.23	69.44	70.05		
All rated	1.65	3.29	4.80	6.11	7.21	8.15	8.93	9.61	10.23	10.78	11.54	1999

*** Starting year of worst 5-year period**

The data shown above is the result of a statistical documentation of corporate defaults among Moody's rated long-term debt issuers since 1983.

This study covers financial institutions, nonfinancial companies, and regulated utilities that have long-term debt ratings.

The database covers the credit experiences of more than 25 000 companies that had long-term rated bonds, loans, and/or deposits between 1983 and 2021.

OTHER BOND FEATURES

ISIN	Bonds are normally assigned an ISIN (International Securities Identification Number), which is a 12-character code that uniquely identifies a security.
144A	144A is a rule of the Securities and Exchange Commission (SEC) in the US. Bonds with the 144A rule are allowed to be bought and held by qualified institutional investors only, which are generally large institutional investors.
REGS	A bond with Regulation S (REGS) is offered to non-US residents under an exception to US securities laws. Non-residents do not get the same legal protection with new issues as US clients do. REGS bonds are available for private investors.
HKEx Chapter 37	Applicable to bond listings on Hong Kong Exchanges and Clearing Limited (HKEx) only. The debt is issued and distributed to Hong Kong professional investors only.
Denomination	The denomination is the face value of a financial instrument. For bonds, it is usually USD 1,000 or multiples thereof (in the case of a USD bond).
Change of control	Change of control (CoC) means that the ownership of the issuer is shifting from one party to another. In this event, bonds with a CoC clause will be redeemed at a predefined price.
Make whole	A ‘make whole’ allows the issuer to redeem a bond before maturity. However, the borrower has to pay a ‘fine’ in the form of an additional payment that is based on a predefined calculation.
Pay in kind (PIK)	A PIK bond allows the issuer to pay interest with additional bonds rather than cash. PIK bonds are speculative bonds, as the issuer is creating more debt, implying that the borrower is unable to pay the interest in cash.
Special purpose vehicle (SPV) with keepwell structure	A contract between a parent company and its subsidiary to maintain solvency and financial backing throughout the term set in the agreement. This is a method by which subsidiary companies may increase the creditworthiness of debt instruments and corporate borrowing.
Lock-in period	The period of time in which a loan may not be prepaid and when a lender will guarantee a certain interest rate on a loan to be extended by it in the future.
Callable	The bond can be redeemed by the issuer prior to its maturity.
Puttable	It allows the holder to demand early repayment of the principal from the issuer or a third party acting as an agent for the issuer, and the repurchase price is set at the time of issue.
Discretionary deferrable cumulative coupon	The issuer has the discretion to pay a coupon. Deferred cumulative coupons are interest that has not been paid but is accumulated and paid later, most of the time cash compounding.
Discretionary deferrable non-cumulative coupon	The issuer has the discretion to pay a coupon. Deferred non-cumulative coupons will be cancelled and hence not paid.
Extended maturity	A bond that includes the option to lengthen its maturity date.
Deferred interest payment	A bond that pays interest at a later date instead of in periodic increments.

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