Navigating Corporate Bonds

Webinar Transcript

RICHARD CARTER: Hello. And welcome to our bond investing seminar. Thank you very much. Today, I'm delighted to welcome Steven Shaw back to our fixed income webinar series. Steve is founder and president of BondSavvy. It's a research service specializing in helping individual retail investors investing individual corporate bonds. Steve is a 27-year veteran of the financial markets, working in corporate mergers and acquisitions, as well as heading up bond market trading venue Tradeweb Direct, one of the firms that Fidelity actually partners with for its bond inventory.

Steve founded Bondsavvy in 2017. So Steve, welcome. It's great to have you back here and to discuss what you're currently seeing in the corporate bond markets. And for the benefit of our audience, I'd like to just start by asking you, if I may, what inspired you to choose this title as the theme for your presentation today?

STEVEN SHAW: Of course. And thank you very much, Richard, and to Fidelity for hosting today. So I'd say it's a very similar reason for why I decided to have this skier skiing a mogul run on the cover and that if this skier got to the top of the hill and she saw moguls in front of her and it never really knew-- didn't know anything about him, was never really told what can happen or how to ski down him, she'd probably say, you know what? I'm not going to go down this.

It's too-- it's fraught with too many obstacles. And the person could go and ski another trail and be perfectly happy. And a lot of people do that with corporate bonds and that they say, I've got to learn about yields. And I got to learn about this. And these things can happen. But the problem is that if you avoid corporate bonds, you're really missing out in that you're missing out on contractual income. You're missing out on contractual return of principal, potential for capital appreciation. And so the purpose of this presentation is to equip people, so that they know what to

expect and they can confront the challenges, so they can successfully add corporate bonds to their investment mix.

RICHARD CARTER: Thanks, Steve. OK. Well, that sounds worth doing. With that in mind, maybe you could just pass a few seconds here on our disclaimer, which is to say that while we welcome Steve and we're really grateful to have him here, we present today's meeting in the spirit of education and healthy discussion. The views that Steve proposes are not held by Fidelity necessarily, and we have no role in actually crafting Steven's presentation.

So again, just for everyone's information, this is separate from Fidelity. But again, we're really welcoming him and happy to have him here today. So Steve, coming back to this topic then, yes, I mean, you alluded to the fact that there's so many different vehicles that one could invest in fixed income, funds, ETFs, et cetera. Why again, put that effort in to diving into the world of the individual security?

STEVEN SHAW: What I would say to that, Richard, is that when you think about individual corporate bonds, they provide investors with three things that they need that investors need and hopefully want that the very few other investments offer. So they offer contractual income. They offer safety because you have a contractual return of principal. And you have potential upside with capital appreciation. And what I show here, Richard, on slide three is a comparison between individual corporate bonds, which is in the right column and stocks and bond index funds.

And why don't we start with one of the disadvantages? And then we'll turn into some of the advantages. So in terms of the disadvantage, if I was to compare individual corporate bonds to, say, a bond index fund, I would say that reinvestment ease is a little bit-- there's certainly an advantage with bond index fund because It happens without you really needing to do anything. You're going to get the income every month. And that's going to get reinvested with individual corporate bonds.

If you own, say, 10 bonds of apple, you're going to get that interest income every six months. But then it's going to sit in your Fidelity account. And then you need to

ultimately then reinvest that. So it does take some human interaction. What I will say when you look at some other things-- so we talked about contractual income. As we talked further in this presentation, there are certain things with bonds that don't change. So the coupon that you receive doesn't change.

The maturity date doesn't change. The par value of the bond doesn't change. And that's very different than, say, a stock or a bond index fund, whereas with stocks, the income, yes, stocks can pay dividends. But then they can also take those dividends away overnight. And bond index funds, the income is variable. We like to look for value with corporate bonds. And you can do that with a corporate bond because all corporate bonds are priced off a percentage of their face value.

So you can look at a company's financial metrics. You can compare it to where the bond is trading relative to par value and start to assess value. And you can also create a portfolio that is really tailor made to what you want in that you can create a portfolio of, say, 20, 30, 40 bonds of different industries, different maturity dates, different credit quality and create a portfolio that fits your needs, whereas it's very difficult to do with, say, a mega bond index fund. So those are just some of the advantages that show it is worthwhile to ultimately learn the things that you need to learn before you invest in corporate bonds.

RICHARD CARTER: Thanks. Thanks, Steve. OK. Well, a lot of green on the screen there. That's pretty good. Let's assume people agree with your idea of it's worth tackling. I think the next question would be, where would one Start There are so many more corporate bonds out there than, say, for example, corporate equities. So can you begin, for example, by using some of the same techniques that you might do for stock investing over in corporate bond investing?

STEVEN SHAW: Sure. So one of the things we're going to show today, Richard, is we're going to talk about some of the fundamental analysis that we do, as well as some of the shortcomings of that fundamental analysis. And we're going to start with-- we're going to start with a case study because one of the things that can be

frustrating from a bondholder standpoint is that oftentimes, shareholders can seem to be given greater priority. And I challenge anyone to find a CEO who's who said, we're doing everything that we can to enhance bondholder value.

I don't think anyone's ever said that. They obviously just fall over themselves to talk about shareholder value. And that can be frustrating from a bondholder perspective. But what it does is it shows us how we can use fundamental analysis and financial analysis to ultimately figure out where there could be value in the corporate bond market. And we're showing here on slide five, Richard, is we show a comparison between two companies, Lockheed Martin, obviously a huge defense contractor and M/I Homes, which is a mid-sized US home builder.

And we're going to zero in on a few different metrics. And the first one is what I have here in yellow, which is called free cash flow. Now, most people have heard of a company's cash flow. That's obviously the profits of the company, and perhaps, some working capital and things like that. But when you need to figure out what amount of money the company has to say, pay down debt or to distribute money to shareholders, you need to subtract the company's capital expenditures.

So that's what it invests in its plan and all sorts of things like that. And so you'll see here that Lockheed Martin has very healthy free cash flow. So if you look at 2023, it had over $6 billion. And M/I Homes is a much smaller company. So in 2023, it had $523 million, but obviously, growing over the last several years. But then the question from a bond holder perspective is, OK, well, is the company's debt balance going up or going down? What's going on with the cash balance?

Is it becoming more credit worthy or not? And you'll see here what I show in orange is the total shareholder related expenditures. And that includes stock repurchases and dividends. And you'll see here that Lockheed is huge in terms of what they're giving out to shareholders. So you see in 2022, it was $10.9 billion. They only had $6.1 billion coming in. So it was 178% of their free cash flow was going to shareholders. And you compare that to, say, M/I Homes where in 2022 was 36%.

2023, it was 23%. So M/I Homes is a company, yes, much smaller than Lockheed Martin. But their cash flow is growing. And they're not giving it all out to shareholders. And that has a significant impact in terms of the financial wherewithal and the ultimate credit quality of the company. And so you'll see here in the next line, it says debt issued or repaid. And so Lockheed Martin, because it had more cash going to shareholders than from the business, it had to issue more debt.

So it issued $4 billion of debt in '22, $1.9 billion in '23. And you see that hardly any new debt being issued by M/I Holmes. You see the cash balance, again, a different story. Lockheed Martin's going down from 3.6 billion down to 1.4. And M/I Holmes is going up. And one might expect that, well, the rating agencies would reflect that in their rating. But they actually don't. You actually see Lockheed going from A3. So the ratings that we show here, A3 minus-- those are the Moody's and S&P ratings. Moody's actually upgraded it a notch. M/I Homes had had similar bond ratings. But you see that you can have a company like Lockheed Martin. Because it's such a big company compared to M/I Homes, which a smaller company, Lockheed has got this A-rated-- has an A rating compared to BB with M/I Homes. And obviously, if you were to look at bonds of the different companies, M/I Homes would pay you more than a Lockheed bond. And so that's where you can try to find value within corporate bonds.

RICHARD CARTER: Well, thanks to you, some great analysis. They're really, really interesting. And I think it just shows you it's always worth going deeper than just relying on the ratings to do all the work for you there. Anything else? As you say, you think shareholder value is primary, and yet you hear debt in the capital structure bondholders come first. If I am a bond holder, anything other-- other aspects I should be aware of or on the lookout for, if you like, that might happen to me as a bond holder.

STEVEN SHAW: Yes. So when we look at this analysis that I show here on slide five, Richard-- so let's say we were thinking about a new investment in one of these

bonds, that's analysis that we can do. And we can see, OK, what does the company look like when we make the investment? But things change. And I'll give you the next case study is a Macy's case study. And what's important-- so as you mentioned before, you said that bondholders are senior to-- or senior to stockholders
And that's obviously true. But one thing that can happen is as a company operates, different things can happen. So if we look at, say, this, the Macy's financials, what we show here is we show financials over a several year period. And we show the company's cash. We show its Debt we show its EBITDA, which is the company's earnings before interest, taxes, and depreciation, also known as its cash flow. And we see how those have changed over time.
So you'll see February 1, 2020-- this is before COVID. The company was looking pretty good. So it had $685 million of cash, $4 billion of debt, EBITDA of $2.3 billion, and a leverage ratio, which is just the company's debt divided by its EBITDA of 1.8 times. Now, COVID happened. And Macy's had to shut down its stores. And what Macy's did was it issued secured bonds. So those bonds were secured by Macy's real estate. And what happened was Macy's then had senior debt to the bonds of about $1.7 billion.
When it issued those bonds, it also got cash. So the cash became 1.7 billion. But it was just important to know that as a bond holder at that time, you were junior to those senior bonds. And that can happen. And at the end of that fiscal year, Macy's was in a little bit of a pickle because if you look down here, EBITDA had gone all the way down to $117 million. You had a huge increase in the leverage ratio up to 42 times. And luckily, as you moved forward, Macy's had a turnaround.
And what it did it was able to pay down the senior debt. Cash went-- it was able to use the cash on hand to pay down some of the senior debt. And you compare it to what it was January 28 of '23 compared to February one of 2020, it was in a much better spot. So it's important to know that things can change. And once you make an investment, you need to keep updating it because you could have a case where a

company turns into it has a little bit of financial difficulties, and you might need to reassess your investment.
RICHARD CARTER: Yeah. s That's amazing, isn't it, that volatility there in the results? I mean, I can only imagine, if you own any of the assets, if you own the stocks or the bonds, you're going to see quite a swing in-- and as you say, it was a tough time with COVID and if you're in retailing. So how would this type of swing be reflected in market prices? And would you be better being a bond holder, perhaps, than an equity holder?
STEVEN SHAW: Well, it is really interesting to see how events such as this, such as COVID can impact both types of investors, both a stock and a bond investor. So we look at slide seven, Richard. And this is comparing the Macy's stock on the left to a Macy's 4 and 1/2 2034 bond on the right. And what you'll see here is we show the last five years, so we show April 1 of 2019, you'll see that the stock was trading at 2447. And then unfortunately, you had COVID happen.
And when they started closing their stores and then the stock went all the way down to $4.43, so a huge loss for stockholders. But then Macy's started having a turnaround plan. So they were able to gradually reopen their stores. You'll see here that they suspended their dividend for about 18 months to conserve cash. And as the company turned around, so did its stock. And the stock went up almost 10-fold to close to a little bit North of $37 in November of '21. But then Macy's has had its decent performance the last couple of years, but it's been somewhat mixed.
And the stock went down. So now you look at the end of March, it was 1985. And the total stock return was about negative 5.5%. Now, it's different when you look at the bond because with the bond, you have that 4.5%. You have that every year. So even as Macy's encountered difficulties, as a bond holder, you kept getting that 4.5%. Yes, you did have volatility. So April 1 of 2019, the bond was priced in the mid 80s. And as the company was having financial issues where it needed to issue new debt, the bond did fall to 47.

Obviously, didn't fall as much as the stock. But then gradually, the bond recovered. And as bond markets had indigestion in 2022, the bond fell. But now it's recovered quite nicely. And that all happened with lots of turmoil. So you had huge sell off in the bond market in 2022. You had obviously all the stuff that happened due to COVID in 2020. But because of that 4 and 1/2 percent coupon, you were able to still achieve a pretty good return of 29% over the last five years for a company in a fairly difficult sector. So it shows the benefit of first having that fixed income, and also knowing that your senior in the capital structure, and that you're going to get your principal back in 2034, so you can weigh this situation out with Macy's because, as I showed before, it's still a reasonably financially strong company.

RICHARD CARTER: Thanks. Yeah, that's great. So let's keep going down this road of the fixed terms, if you like. You said the coupon, which was fixed for the life of the bond and then the term that maturity the principal is repaid. What are some of the other key terms, do you think, of terms and conditions that an investor should start looking out for as they look at the investment opportunity?

STEVEN SHAW: Sure. So one of the big things to think about, Richard, is call schedules. And we're going to talk about some of the other terms of a bond that are fixed and as well as things that can change because over the life of a bond, things can things can definitely change. So when we look at call schedules-- and all a call is, for folks who might be new to bond investing, is that everyone's heard of a maturity date. So at that maturity date, the issuing company has to pay you back the face value of the bond at maturity.

And that face value of the bond is $1,000 per bond. So if the bond is due in 2034, they have to pay you back that $1,000 on whatever maturity date in 2034. Now, companies then have what are called call provisions of with their bonds. And those call provisions will generally fall into two categories. And they'll be differentiated by whether a bond is a high yield bond or an investment grade bond. And when I say high yield bond, all I mean is a bond that's rated below B by the rating agencies.

If it's B and higher, that's an investment grade bond. It's one key term difference between an investment grade and an A high yield bond. The other key difference is the time to maturity when the bond is initially issued. So an investment grade bond, such as an Apple bond, typically, when it's originally issued, could have a maturity date of 20 to 30 years, whereas a high yield bond might have a maturity of, say, five to 10 years. So we're going to give two examples here.

On the left side-- and this is within the Fidelity ecosystem. So let's say I search for a bond, and I said this ScottsMiracle-Gro bond looks interesting. And you're going to see some different terms here. So you're going to see ScottsMiracle-Gro. And then you're going to see 4%, 4/1 2031, and then call make whole. And I'll explain what that is in a moment. And similarly with Apple, you see 3.45% due in 2045.

And that, too, says "call make whole." When it says "call make whole," what does that mean? So any time a bond has a provision called a make-whole call, that is very advantageous to the bondholder because-- let's look at this bond, this Apple bond. So, over here, you see it has a maturity date in 2045.

If Apple wanted to call that bond from you, so if it wanted to redeem the bond, it would have to pay you the present value of all the interest payments and principal payments between now and 2045. That's a huge number. So, unless if the CFO wanted to get fired, the CFO wouldn't-- the company would never do that. And that provides protection for bondholders because you don't have to worry about the bond being called, because if, for whatever reason, they said, all right, we're going to call it, then you'd be delighted if that were to happen.

Now, a high-yield bond, such as this ScottsMiracle-Gro bond-- and so you'll see, here, you go down in the blue. It says, Moody's rating-- B2, B minus. That's obviously below BBB, so you know it's a high-yield bond. Now, it says "call make whole." It technically is a make-whole call right now, but the bond does have a call schedule, which is going to impact how high this bond price can go. The way you find that out

is if you come down a little bit farther. You'll see redemptive features, and then it says call protection.

Now, it says no, but then, if you click View Schedule, that's what you need to click because that gives you the next level of information that's really important for a bondholder. And what we show here is we show the ScottsMiracle-Gro bond on the left, the Apple bond on the right. This is when you click that View Schedule hyperlink. And you'll see, for ScottsMiracle-Gro, there is a specific call schedule. So it says, on October 15 of '26, that it's callable at 102.

So let's say that the bond right now is priced at 99. You know that the company can call it back October 15 of '26. There's not going to be a lot of capital appreciation on that bond, because the bond's not going to go up to 110, because who would want to be the person who bought the bond at 110, and then, in a very short period of time, it goes to 102? And so that's where it's a key differentiator between a high-yield bond and an investment-grade bond, because you'll see here, with the Apple bond, there is no call date. There is no call price, because it's make-whole call for the entire term of the bond, whereas the ScottsMiracle-Gro-- it is going to have a ceiling on that bond price because of the call schedule.

RICHARD CARTER: Thanks, Steve. That's really helpful. Of course, call features and call structures are so commonplace in corporate bonds, so it's really helpful education. But one of the risks that we often speak to our investors about with callable bonds, of course, is that issue of reinvestment. You're holding a bond, it gets called, and then you find you have to reinvest when rates may be lower than when you had originally invested, and so maybe you shouldn't have done.

So let's maybe think of the scenario that we were in a bit today, where rates are higher. And maybe they're even going higher-- we don't know-- but let's say rates continue to be fairly buoyant in general. Does it make you care less about callable features, or what would you say?

STEVEN SHAW: Well, I would say that, when you think about call features, a lot of it has to do with comparing one investment to another because, like we show here, this ScottsMiracle-Gro bond-- it's apples and oranges because, obviously, ScottsMiracle-Gro is a different credit quality than Apple. But the ScottsMiracle-Gro coupon is 4%, and the Apple coupon is 3.45%. So one of the things that's important to do as a bond investor is think, OK, if the bond gets called, how does that impact my decision, in that-- do I want to take the extra coupon but, perhaps, have that risk with the call provision?

Now, to your question, we're in a little bit of a different environment today than we were a few years ago because today, you've got investment-grade bonds that many of them yield to maturity of 5%, even 6%. You've got high-yield bonds with yields to maturity of 6%, 7%, 8%. So if a bond does get called, you certainly have an opportunity to reinvest at a much more compelling yield than you did a couple of years ago. It's why it's so important to not only look at this when you make the investment-- because you want to be able to compare, OK, what's the bond call feature? How does that compare to where the bond is priced?

But as you move on, let's say you make an investment, and let's say you buy a bond at 90, and it goes up to 101, and it's callable at 104. Then you have to decide, OK, does it make sense to potentially sell that bond? And today, it's a little bit of an easier decision because there are so many other bonds out there that are compelling, in terms of what the yield, where they're priced, than there were, say, in 2020 and 2021.

RICHARD CARTER: OK, all right. Thanks, Steve. All right, well, let's move on now a bit, if I could change gears to the topic of screening or searching. I think you alluded to it. We've got a lot of bonds on our website-- typically over 10,000 corporate bonds on a given day. That's double the equities, so there's a lot to choose from.

What do you specifically look out for when you try to narrow that down to find eligible candidates? In equity investing, people might describe their style, if you like,

as-- I'm interested in growth or in value, or I look out for price momentum or something. How do you, again, just begin to narrow down this rather large universe?

STEVEN SHAW: Sure. I would say, in today's environment, Richard, we're looking for two things. So we're looking for income, and we're looking for value. And so we want to find bonds that pay a high coupon, relative to their risk, and bonds that have capital appreciation. Now, capital appreciation, especially with high-yield bonds, can be hard to come by, especially if a bond is callable at a low price, relative to where it's at. But those are the things-- that's ultimately our goal.

And what we do is-- so we obviously start with the Fidelity universe. So as you said, there are 9,000 bonds. That's certainly a lot to go through. But as we narrow bonds down, we're obviously looking at-- what do we know about the issuing companies? What do we know about the issuing companies' industry? What's going on with interest rates? Would we favor investment-grade bonds, which are going to be generally more sensitive to changes in Treasury yields, or would we favor high-yield bonds, which would have less sensitivity to changes in interest rates?

And so we start to start from a higher level and narrow it down. And then we get into, OK, we might have narrowed it down from 9,000 down to, say, maybe 10 bonds. And then we need to figure out, OK, which are the bonds that we ultimately want to recommend? And that's where we're looking for value. And so we start here.

And we show here, Richard-- so these are four bonds we had previously recommended, and this is the analysis that we show, and we start off with the pricing analysis. And so we show here, on the quote-- and just so people know, who may not be familiar with bond investing, when you see a bond quote, that's a little bit different than a stock quote. So when you see a bond price at 91.33, that just means that the bond is priced at 91.33% of its face value or $913.30, just so folks are familiar with that convention.

So then we start to look at things such as yield to maturity, and then this new number, which we haven't talked about yet, which is the credit spread. So obviously,

the bond is a higher yield. That's going to pay you more over time. The credit spread is something that's important for investors to navigate. And all that is is it's the difference between the corporate bond's yield to maturity, and then the yield to maturity of a Treasury, US Treasury, note or bond, that has a similar maturity date. So let's say you're looking at a corporate bond that has a maturity date in 2030. There's a US Treasury bond that also has a maturity date in 2030. So this credit spread is the difference between those two yields to maturity. So if you're getting a higher credit spread, that means you're being compensated more to take on the higher credit risk of a corporate bond, compared to, say, the US Treasury.

That's really where you start. So you see, OK, well, where are bonds priced, relative to their par value? What are they yielding? What is the credit spread? And then we start to look at financial metrics. And one of those, or two of those, is leverage and interest coverage. So I talked briefly about leverage before, and all that is is that you're taking the company's debt, divided by its EBITDA. So EBITDA is earnings before interest taxes, depreciation, and amortization. It basically tells you how much cash is coming in, and it avoids and it backs out noncash items, like depreciation and amortization.

The lower that number is, the better, because it means you've got less debt, relative to the company's earnings. So if it's anything less than three times, you feel pretty good. As it starts to get up to four and a half and five and seven, that's when you start to get nervous. And interest coverage is looking at, OK, how much cash flow do you have, compared to interest expense? And so if you have interest coverage that's high single digits or low double digits, you feel OK. Alphabet, the parent company of Google, has interest coverage of about 300 times, so you know that they're not going to default.

Now, what's interesting is when you compare two different bonds, and you compare the bond ratings. So here, bond recommendation 2, you see, was A3, A minus, so investment-grade, but it had higher leverage. So you would think, well, how can that

ever happen? You've got this first bond here, which is BB. It has lower leverage. It's paying a higher coupon, compared to this bond recommendation 2.

And that comes to some of the ways that bond ratings are calculated, because this bond recommendation 2-- it's a global company. Those companies often are favored, when it comes to bond ratings, over, say, a US-based company, which is what this bond recommendation 1 is. And so that can happen. And so it's important to look beyond a credit rating to figure out where there could be value.

But that all being said, that's just one point in time. And that's what the bond yields. That's what the credit spread was. That's what the leverage ratio is. So you need to think about, OK, what's happening with this company, and where is it headed? Because if revenues and EBITDA are going down, even if a company's leverage ratio might look good, you might be like, well, the company's having all sorts of troubles. This leverage ratio that's two times today might be four times tomorrow.

So we do is we look at basic financial metrics. So we look at revenue and EBITDA growth. How are those going? So you'll see here, in the green, for this company, it was looking pretty good, growing 15% for revenue, 21% for EBITDA. Didn't have a huge cash balance. But what we look at is we look at margins. So high-margin company-- it's better able to navigate a business hiccup because if revenue goes down, it's still going to be profitable, whereas a low-margin company, such as a grocery operator-- that can fall into trouble.

Then you want to know, OK, does the company have significant upcoming maturities? How does that compare to the company's cash flow? So even though this bond recommendation 1 didn't have a lot of cash, you'll see that it had $6.7 billion of EBITDA over the last 12 months, and its maturities were fairly manageable-- $1.3 billion in '24, 950 in '25. And this bond, because it was high-yield, generally is going to be very little sensitive to changes in interest rates.

So that's ultimately how we're looking for value. We're looking at all these different metrics, and that's how we're able to narrow down a fairly big universe of 9,000 bonds to a small number of select recommendations.

RICHARD CARTER: Wow, Steve. Well, I'll tell you, I think, not only is there that narrowing-down, but I love the way you take a financial statement, which is pages and lines and lines and lines of numbers and things to look at-- and sometimes can overwhelm people. You really distill it down, here, to some of these key financials, I think, would be really helpful for people to remember or look back on as they look at a company.

I'd like to, though, just go back a little bit to the previous slide, where you went beyond just the company and looked at some of that pricing analysis of the bond. And I'd like to just ask you. Again, another challenge, I think, faces people is, because any particular company might issue anywhere from two to maybe 202 different bonds, how to make that choice? And I think you alluded to the credit spread there. How, again, do you pick your spots, if you like, if you like, particularly, a company on its fundamentals?

In particular, when you think about some of the volatility we've seen in-- 2022, for example, was a really "ride the rapids" year for any kind of investor, really. But can you arm yourself to be less exposed than in one part of bond issuance than another?

STEVEN SHAW: Yeah. It's interesting, Richard, because when you're looking at, say, a high-yield bond versus an investment grade bond-- so, oftentimes, with a high-yield bond and a high-yield issuer, there may not be-- maybe you have two to four to five bonds to choose from. There are exceptions to that, but generally, it's a smaller number of bonds, whereas you look at a Ford or an Apple, and you do have 50 bonds to choose from.

And that's the case where, if you're looking at an investment-grade bond, and you've got lots of choices, then it can be a case of, OK, well, where do you think Treasury yields are headed, and where do you think bond yields are headed? Because that

can often have a bigger impact on the bond's performance than the actual financial performance of the issuer. And it's a good segue into some of the limitations that fundamental analysis can have.

And we show here, Richard. We show, on slide 14, an Eli Lilly case study. So here we're showing the stock performance of Eli Lilly from March '21 to '24, and we're showing the performance of one of its bonds, Eli Lilly, 2 and 1/4%, due in 2050. Now, Eli Lilly's had extraordinary financial performance recently. And it's impressive, especially for a company of Lilly's size-- for instance, in Q4, it reported a 28% increase in sales, projecting 20% increase in revenue this year.

And so usually, if you're looking at a huge company, you're pretty happy with mid-single digits or even high single digits, so it's pretty extraordinary growth. And that's been reflected in the stock. So you see the stock, March of '21, was down at $208. March of this year, all the way up to $757, so a very significant return that you would associate with a tech company of 270% over three years.

Now, the bond's been a different story. So if you made an investment in 2021, and you did your analysis on Lilly, and you said, you know what, they've got a nice pipeline, their profitability is strong, and all that kind of stuff-- but with Lilly, because it's a long-dated, investment-grade bond, that bond performance is driven more by what happens with the US Treasury market and US Treasury yields, which were significantly impacted by the Fed hiking rates.

So we show here, on the bottom chart, is we show two things. So we show the price of the Eli Lilly bond over the last three years, and then we also show this new metric called the benchmark US Treasury yield to maturity. And again, just to remind folks, Eli Lilly-- this bond is due in 2050. There's a US Treasury bond that's due in 2050. So when we say benchmark US Treasury, it's just the US Treasury bond that's due on 2050.

And you see the yields here, so you see, March 12 of '21, it was 2.40%. You see the bond price of Eli Lilly. It was 85.31. Fast forward to September 22 of '21. Because US

Treasury yields fell-- so they fell from 2.4% to 1.8%, the bond price went up 10 points. That's a pretty significant price increase. Now you go even further. As the Fed started hiking rates, you see some ugliness in the bond price. You see, it was at 95, and you see it continued to keep going down and down.

And as you look further to the right on this chart, you see October 20 of '23. The 2050 US Treasury yield to maturity was 5.09%, and the Lilly bond was all the way down to 52.96. Now, it has recovered somewhat because Treasury yields did fall a little bit. But despite the strong performance of Lilly, you had a very poor return of -20% because of the limitations of fundamental analysis, especially when it comes to investment-grade bonds.

Now, some might say, well, why didn't you go with a short-dated bond in this case? But at that time, a short-dated Eli Lilly bond would pay a 0.7% yield to maturity. And as folks remember, short-term bond yields actually moved up materially more than long-term bond yields. So unfortunately, with investment grade, it was a really tough area to navigate because there weren't really any bonds within investment grade that had performed well during that difficult period in '22.

RICHARD CARTER: Yeah, it's a reminder, though, again, how much that is influenced by the Treasury market. So does that lead you to be somewhat cautious with longer-term corporate bonds, that you have that duration exposure?

STEVEN SHAW: Yeah, especially-- if you look at where we are now, it's a little bit of a different environment than, say, in 2021, where, 2021, you had very low US Treasury yields. Now you've got yields that are higher. There's still obviously interest-rate risk in the market. But, depending on your goals, if you can stomach volatility associated with longer-term bonds, you can lock in really compelling yields right now. You've got Apple bonds and Microsoft bonds that are paying mid-single digit yield to maturity and have some upside potential if there's a rally in treasuries.

But that being said, it's always hard to figure out, OK, well, if and when there will be a rally in US Treasuries. And so some of the most successful bonds over the last several

years have been many high-yield bonds because those are generally more-- they're less sensitive to what happens with the US Treasury market. They're more sensitive to what happens with the financial performance of a company. And a good example of this is a bond issued by Vital Energy.

So Vital Energy is a mid-sized oil and gas company out of the Permian Basin. And again, we compare the stock and the bond performance. So the bond is a bond that recently had an exchange offer, which we'll explain what that is in a moment. But it had a very high coupon. Had a coupon of 10.125%, reasonable maturity date of 2028. And you compare the bond performance, which we'll talk about in a moment, to the stock performance. The stock performance has followed, in many ways, the price of oil.

You'll see here that there was the spike on June 5 of '22 of $120 of WTI, and that's when the stock price peaked at $114. And then, as oil prices fell in '23, down to about $74 for WTI, then the stock price followed suit. But from a bondholder's perspective, what happened with Vital Energy is that, as oil prices rose, Vital transformed itself. It was able to pay down significant amounts of debt. Significantly improved its credit quality, and that then showed through in the price of the bond.

So even as he had all that volatility with US Treasury yields and the hikes and interest rates, the bond price was fairly stable. So you go back three years, it was 101 and 1/4. Then it went up to 112, and then it did fall a little bit after all the turmoil in '22. But it was only down to 95, and then it was up at 105. So here's the case where, if you remember back to the Macy's case study, you were able to weather the financial issues with Macy's because you had that fixed coupon of 4.5%.

Here you've got a fixed coupon of even higher, of double of that, of 10 and 1/4%. So that and the short-dated maturity solves a lot of problems. And the company's strong financial performance was able to outweigh what was going on in the Treasury market, compared to the Lilly bond, where it didn't really matter what Lilly did, from a

financial perspective, because that particular bond was so heavily influenced by what happened with the US Treasury yields.
RICHARD CARTER: Well, that's very interesting. Yeah, so that really strong coupon there is a bit of a insulator. And even who would have imagined that oil prices would have gone negative at one point in the COVID period?
STEVEN SHAW: And now there is, actually, if I could just interject one thing--
RICHARD CARTER: Yeah.
STEVEN SHAW: So you'll see here that the bond was priced at 105. And people might think, well, wow, this bond was paying 10-plus percent interest. Why didn't it go up to 130? And if you remember back to call provisions, this bond was callable at 105, beginning on January 15 of '24, so that put a ceiling on this bond. So even though the financial performance of Vital was excellent, you had a huge coupon, you were limited, in terms of how high this bond could go up in its price.
RICHARD CARTER: Right, right. So I guess you could have been-- could've foreseen that, right? And I think, if I could just begin to conclude the discussion, Steve, you've covered a lot of things today that can help us try to avoid some of the mistakes, if you like, or unexpected things. But life is always unexpected despite all the best planning. So could you maybe share a few examples of cases where you've invested in a bond, or you've thought of investing in a bond, at least? And you could never have known some of the things that would happen, and then, how do you react in those cases?
STEVEN SHAW: Sure, so I'll give you two examples, and these are of companies being acquired. And one turned out well for bondholders, and the other has been mixed. So the first example, on slide 16, is an example of a Tiffany bond. So Tiffany, obviously-- makers of very fancy, fancy jewelry. So if you go back to September of 2019, this Tiffany bond-- so it paid a nice coupon, 4.9%, due in 2044.
It was priced at 103.22. Then, one of the benefits if you own a select portfolio of bonds is that, if the company that issued your bond gets acquired, that debt would

be assumed by the acquiring company. Now, if the acquiring company has a higher credit quality than the issuing company, then that bond should go up in price because, once that bond gets assumed, it's going to take on the creditworthiness of the acquiring company.

So what happened was-- it was announced in November of 2019 that LVMH was going to buy Tiffany, and that caused the bond price to go up nearly 25 points. So it caused it to go up to about 128. Then you had the onset of COVID. You had Treasury yields fall significantly. So again, in the orange, we're showing 20-year US Treasury. So you'll see here, it fell from 1.91% down to 1.09%. That caused another 20-point increase in the bond.

And so that's the case where you can have some things work for you in individual bond investing that can really work to your advantage. But it's important for investors to know that this isn't a stock, and so the Tiffany bond wasn't going to go up to 200. It wasn't going to go up to 300. It was at its max.

And so that's where we always support a more active approach to bond investing where you can maximize total return, capture a bond's capital appreciation, because, had you held on to this bond all the way through 2022, where the bond market got crushed, this bond was no longer worth 150. It was worth 85. And the reason for that is because US Treasury yields went from 1.5% all the way up to 5.27%. And so it just shows that, yes, an acquisition can work in your favor, but then it's important just be aware, in terms of where the bond is priced and where it can potentially go.

And last but not least, we're going to give an example of another bond that one would think would benefit bondholders. So this is a case of Activision Blizzard, huge video-game operator. It was announced to be acquired by Microsoft, so one of two AAA issuers in the United States. It was announced to be acquired January 18 of 2022. And we show here, it shows the bond price of the Activision bond. And you'll see here that it fell significantly, and it fell significantly because it was an investment-grade bond. Treasury yields rose significantly.

But the rationale for holding on to this bond was that, at some point, Microsoft was going to acquire it, and Microsoft was higher credit quality than Activision Blizzard, so the bond should have traded up to where a comparable Microsoft bond was trading. As folks will remember, there was obviously a very long legal tussle around Activision Blizzard, antitrust and all that kind of stuff. But in October of '23, the deal finally closed. And you think, ah, all right, we're finally going to see some price appreciation.

But then Microsoft announced what's called an exchange offer because it didn't want to have these Activision bonds in its capital structure. It wanted to have Microsoft bonds. So it said, all right, this Activision bond, this Activision bond which is 2.5% of 2050-- that's now going to be a Microsoft bond with similar terms, but that bond, this exchange, is only going to be available to qualified institutional buyers, so not available to individual investors like you and I.

And what happened is that nearly 3.5 billion bonds got called. The liquidity of the Activision bond fell significantly because the bond was no longer available on many e-trading platforms, and so the price has fallen. And now it trades at a discount to where it really should be trading. So things like that-- and again, this isn't a disastrous scenario, but it's just one of those scenarios where you'd think that it would turn out in the bondholders' favor, but because of what Microsoft did, in terms of how it affected the exchange offer, it hasn't turned out well.

RICHARD CARTER: Well, thanks, Steve. A lot to chew on there, for sure. And we have a lot of questions. We can turn to some questions. But before we do, I'd just like to pause for a second and ask you if you wouldn't mind, in your words, summarizing some of the takeaways from today. I think you're always very honest about-- you're not painting a rosy picture, necessarily. Life is complex, and investing is difficult. You've shown some great sides of the same coin and, in the process, I think, enlightened us as to-- you can do this financial analysis. It is possible. You can learn a

lot from it. But what would you say, in terms of, again, a way of approaching and being in control, if you like, of this decision in a thoughtful way?
STEVEN SHAW: Sure. So I'd say there's certainly work involved when you make corporate bond investments. There's analysis that I believe is important to do. Bad things can happen, and things that-- sometimes they can be either-- they're in your control, from the standpoint of the financials of a company, because you can do good analysis and determine whether it's a creditworthy company, then things that can be out of your control, in terms of what happens with interest rates and other things going on in the market, whether it be mergers.
But I will say that it can be worth it because, if you look at some of the examples that I showed, even during volatile times, whether it be the Macy's bond or the Vital Energy bond or the Tiffany bond-- those are types of returns that you can't really achieve with a bond index fund, and so there is a benefit to learning about this. But just know that it's not a straight line, that there are going to be some peaks and valleys.
RICHARD CARTER: All right, Steve. Well, thanks very much again. Well, let's turn to some questions. We have a lot here. I thought one that caught my eye was what types of corporate bonds-- this is back to the inflation theme. What types of corporate bonds do you think would potentially do well in an inflationary environment, versus the deflationary type of world we were in?
STEVEN SHAW: Sure. So I think the first thing you need to think of, when you think of an inflationary environment-- so how does that flow through, in terms of what's going on with interest rates? So that's one part of it. If it's inflationary, you've obviously got interest rates going up. That's a less favorable environment for investment-grade bonds, compared to high-yield bonds, because a lot of high-yield bonds were able to hold their value during this latest increase in interest rates.
But then you need to think about, OK, what companies can actually benefit from inflation? And there you start to think about oil and gas companies, where you've got

increasing oil prices that can obviously buoy the financial results of a company. You look at some mining companies which have been buoyed by higher prices for gold and copper and silver. And then an interesting one is home-builders, because one would think, well, anytime interest rates go up, it's bad for home-builders because there's going to be less appetite to buy homes.

But what's happened with the home-builders is that home prices have gone up because there's such a limited supply, because people don't want to get rid of their 2.5% mortgages, and those companies have done really well because they've basically been the only game in town. They've benefited from price appreciation. And there can be an issue, in terms of margins, in terms of what happens to the price of lumber and different things like that. But those have actually done very well over the last several years. And you may not necessarily have thought about that, thought that that could be possible, especially with higher interest rates.

RICHARD CARTER: All right. Thanks, Steve.

Another one here. It's a little bit of a market call, but I think it's probably interesting for many in the audience. Do you see an increase in defaults amongst major issuers in the next, say, year or two? You mentioned how tight spreads have become right now, as a consequence of the economy doing pretty well. But if we saw that turn, do you think that could be a danger for the corporate bond investor?

STEVEN SHAW: So I'd say it's really on a issuer-by-issuer basis in that it's hard to make statements in terms of, well, there could be more or less defaults, because, actually, a default has an interesting definition in that-- let's say a company had a difficult time, and its bonds fell significantly. If it started to have a tender offer at a price that's below par value, that would actually be deemed a default because it's giving some investors back less than the face value of the bond.

I will say that, generally speaking, the economy has been strong. Especially when you go and you look at specific issuers, you can find issuers that can withstand a difficult time. But you do have cases-- and that's why one of the things that we look at is

upcoming maturities, because you need to zero in on those things, because if you look at recent bankruptcies that happened in retail, that was because you had bond issuers that had near-term maturity dates, and they had a failing business, and they didn't have enough cash on the balance sheet, and they weren't able to fulfill their obligations.

So it's really case by case, in terms of how we would approach something like that.

RICHARD CARTER: But at least that's building in that buffer, that resiliency. I think you're right with that.

Here's another one. This talks to, again, the interest I think we've seen in all those financials you showed, Steve. How do you, then, keep on top of these financials? So let's say you have your portfolio of corporate bonds. It's dynamic. Results are being posted. Prices are changing. Do you have any tools that alert you to a change in a certain variance from where you initially bought the bond, and that would alert you to be cautious or on your guard for maybe selling, if you had to?

STEVEN SHAW: Sure. So we receive all the email alerts from investor relations departments from all of the bonds that we recommend. So we know any time a company files something with the SEC, any time there's a press release. And then we update our recommendations every quarter, after companies file their financials. Then we see, OK, where is each bond issuer, with regard to financial performance, but then, also, where is the bond priced, relative to others? And then we're making a new call, in terms of a new buy/sell/hold call, as that goes on.

Now, there can be cases where you need to make a call between quarterly financials. Obviously, when a company reports quarterlies, that's the big update, but then different things can happen. There could be a large financing transaction, or there could be an acquisition. Or oftentimes, what will happen is we might receive a notice that a bond is being called, or potential exchange offer, and then we have to decide, OK, is that something that we want to participate in?

So that's part of our services, what we offer. But for an individual investor doing this on his or her own, you do need to pay attention to what's going on at the company because, as we talked about before, things are always changing.

RICHARD CARTER: Great. Thank you, Steve.

Here's one that's a little bit of a technical question, throw at you here. If someone's thinking of selling a corporate bond, should they wait until just after the coupon was paid?

STEVEN SHAW: Yeah, no, you don't need to do that. So there are lots of factors to think about when you're looking to sell a bond, in terms of, what are the financials of the company looking like? What does the call schedule look like? Are there tailwinds or headwinds for the industry? But when you buy or sell a bond, the way to think of it is that corporate bond pays interest twice a year.

So it's now April 24, and let's say that we're thinking of selling a bond, and that bond doesn't pay interest again until June 1. What's going to happen is that, when you sell that bond, you're going to get, from the buyer, not only the principal amount of the bond, but then all the interest that's accrued from the last interest payment date up until the date that the trade settles. So you don't need to wait until the next interest payment, because the accrued interest is going to be part of your transaction through Fidelity.

RICHARD CARTER: So changing daily sort of thing, as you say?

STEVEN SHAW: Yeah, it's always going to be accruing between the interest payment dates.

RICHARD CARTER: Right, right. All right, Steve. Well, I think we're-- probably just time for one more. Squeeze one more in here. Yeah, here's a funny one. On one of your slides, you showed a lot of that financial data that we enjoyed. Where did it all come from? Does it come from Fidelity's website?

STEVEN SHAW: Sure. So when we look at financial information, I'll give you two examples. So we look at this financial information. So I am manually pulling that from

company SEC filings and then doing calculations on my own, in terms of calculating the company's free cash flow and leverage ratios. On something such as this, the prices-- those will come from Fidelity. So those are obviously all available on Fidelity. But then all these other metrics, in terms of credit ratios, leverage, margins, growth-- those we calculate on our own.

And then, for the upcoming maturities, that's when we go into a company's SEC filings and look at the company's debt schedule to see, OK, what bonds does it have, and when are they maturing?

RICHARD CARTER: All right, Steve, Thank you. Well, you certainly earned your subscription fee, I think, if that's anything to go by. Certainly a good bit of legwork you do there. Thanks very much.

OK, well, I think that concludes today's presentation. If we didn't get a chance to answer your question submitted online, we do certainly encourage you to submit your name, phone number, and email address in the Q&A tool that's in the presentation today, in the webinar today, and then a Fidelity associate can contact you back. If you'd rather call us directly, please use the number of 800-544-5372-- that's 800-544-5372-- and ask to speak to an associate specializing in bonds and corporate bonds.

For questions related to Bondsavvy, see the information here. Thanks, Steve. You can reach out to Steve directly at his email address there, and I'm sure he'll be able to, love to talk you or help you. So with that, thank you again, Steve. It's been wonderful to host you again, and really interesting presentation. A lot of things to think about there.

STEVEN SHAW: Of course. My pleasure, Richard. And thank you so much for hosting another webinar. I really appreciate it.

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