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In the last issue of the Fortnighter we discussed return expectations for bonds and "high-yield" bond funds. In retrospect, I probably should have explained in more detail how bonds "work" and the implications for holding bonds in a dynamic investment environment.

First, bonds are a vehicle for investors to lend money to an entity such as a government or corporation. The price we pay for a bond (i.e. the yield we are willing to accept) is primarily based on the length of time we're lending the money (the bond's maturity date), the credit worthiness of the issuer and our expectations for future financial conditions – such as inflation.

A full discussion of bond features is beyond this space available in this issue so I'll focus on one aspect of bond investing – credit quality. Nowhere else in the investment world is it so clearly articulated that an investor must be compensated for a higher risk with a higher return. With common stocks, the difference in risk between stocks is really open to interpretation. With bonds, however, risk levels are clearly spelled out – a tremendous amount of importance is placed on quantifying the credit quality of individual bond issuers (the ability of the issuer to both make interest payments and pay out principal at maturity).

The most commonly used indicator of credit quality is Standard & Poor's "ABC" scale. "AAA" is the top rating, "AA" & "A" are next, then "BBB" etc. on down to "C" (vulnerable) and "D" (in default). For example, Canada has an "AAA" credit rating, TD bank is an "AA", Manulife is an "A", Telus is a "BBB" and so on.

BBB is generally considered the lowest investment grade. Bond issues below this are considered speculative and more vulnerable to changes in business and economic conditions. These are typically the bonds that make up the majority of the holdings in "High Yield Bond Funds".

This brings up one more element in the bond-pricing equation: Supply and demand. Investors will pay more for bonds (i.e. accept a lower yield) when supplies are tight and yields on alternatives are poor. This has become the situation in the US high-yield market and, to a lesser extent, in Canada. Yield-hungry investors have been aggressively buying lower-quality bonds and driving up prices – to the point where interest rate "spreads" between high-yield and AAA bonds are now lower than they have been in years.

An unwritten rule in the investment business is that things inevitably gravitate to the mean. Cautious investors with above-average exposure to high-yield bonds may want to start trimming positions while demand is still high.

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