As Corporate-Bond Yields Sink, Risks for Investors Rise

By MATT WIRZ

In July, TransCanada PipeLines sold $500 million of 10-year bonds to investors. The interest rate: just 2.5%, down sharply from the yield of more than 3% that investors demanded on the energy company's bonds as recently as December.

"When you have that opportunity, you go," says Donald Marchand, executive vice president and chief financial officer at TransCanada Corp., the Calgary-based parent of TransCanada PipeLines. While money is dirt cheap now, eventually "there's only one direction rates ultimately go, and that's up," he adds. "We're preparing for this by borrowing long-term money now."

Companies sold $75 billion of investment-grade corporate bonds in the U.S. last month, the busiest July ever for such sales, and the total for 2012 is on track to hit $1 trillion, according to ThomsonReuters. Corporate bonds sold last month pay an average interest rate of about 3.2%, an all-time low. Over the past 30 years, interest rates on those bonds averaged about 7.2%.

For many investors, the appeal of investment-grade corporate bonds is obvious. Interest rates on Treasury bonds are even lower—and likely to stay down for at least the next year or so.

But skeptics say the ravenous demand for corporate bonds has pushed yields on the securities down too far to compensate investors for their risk. They point out that even companies that don't need the money right now are issuing bonds because the borrowing costs are too low to pass up, and they see this as a warning sign for investors.

When interest rates eventually rise, prices of recently issued corporate bonds will fall. "The guy buying a [new] bond today is a guy buying a certain loss," says Anders Maxwell, a managing director at investment bank Peter J. Solomon Co. "Rates have to go higher, and when they do these low-coupon bonds will drop precipitously in value."
The stampede into corporate bonds is part of a broader shift in how investors view risks in the wake of the financial crisis. Stocks are widely distrusted, especially by individual investors, after more than a decade of lousy returns and wild price swings. Few people are clamoring to buy stocks despite the Dow Jones Industrial Average's rise of 8.1% this year. Last week, the Dow gained 0.9% to 13207.95, and it is within striking distance of its 2012 high.

Reuters

Anheuser-Busch InBev is among a slew of corporate-bond issuers lately.

But with yields of close to zero on investments perceived to be the safest around, such as short-term U.S. or German government debt, investors hungry for higher returns are being forced to look at slightly riskier assets. Corporate bonds are one of the favorite targets lately, and some investors see them as having a new "haven" status.

"I've been doing this for 23 years and I've never seen demand for new issues this large," says Jim Probert, the head of investment-grade banking at Bank of America.

With some new corporate bonds, investors are setting themselves up for inflation-adjusted losses even if interest rates don't rise. Highly rated Texas Instruments sold three-year bonds in July at a yield of 0.60%, while three-year bonds from Anheuser-Busch InBev sold with a yield of 0.80%. Those returns will be wiped out by inflation, which stood at an annual rate of 1.7% in June.

"This year, the strategic opportunity that presented itself was the historically low interest rates," Alan Boyd, Texas Instruments vice president and treasurer, wrote in an email. "We intend to use these funds for general corporate purposes, which, among other things, could include stock repurchases."

But for investors in such bonds, the effects could be painful if interest rates climb.

With TransCanada's bonds, for example, if five-year Treasury yields return to their 20-year average of 4.3% by 2017, and the company's yield spread of one percentage point over Treasurys stays the same, then the 10-year bonds sold last month would yield 5.3% in 2017, when there are five years left on the bond. That means they would trade at 88 cents on the dollar rather than 100, canceling out almost all of the interest payments on the bond and leaving holders with a return near zero.

Nevertheless, many asset managers and individual investors are brushing aside such scenarios because they believe it will be years before there is a meaningful rise in interest rates. And whenever rates do rise, the bet is that any increase will be gradual enough that they can maneuver their portfolios and avoid significant losses.

July was a psychological turning point for many investors, says BlackRock's chief investment officer for fixed income, Rick Reider, who oversees more than $600 billion in assets. Guidance from the European Central Bank and Federal Reserve combined with continued negative yields in German treasury bonds strengthened the consensus that "interest rates are not moving up anytime soon," he says.
And while rates on corporate bonds have sunk to new lows, the incremental yield—or spread—they pay over Treasurys is close to the 10-year average of 1.8 percentage points. Some experts believe the spread could fall further, which could boost corporate-bond prices in the near term.

Also fueling demand is a view that companies, flush with stockpiles of cash, are in some ways more secure as an investment than are Treasurys and other debt from governments facing huge deficits.

"U.S. corporate bonds are becoming a flight-to-quality asset class," says Michael Seigel, global head of insurance asset management at Goldman Sachs.

Investment-grade-bond mutual funds and exchange-traded funds in the U.S. took in $69 billion this year through July, compared with an inflow of $2.1 billion into Treasury funds, according to Lipper.

"What people, particularly retail investors, have never understood is...while double-A bonds may have no apparent credit risk, they have tremendous interest-rate risk," Mr. Maxwell says.

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