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Credit Investing A Primer on Debt Investments

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Most investors are familiar with the concept of a balanced portfolio – containing a blend of equity and debt investments. What many investors may not realize however, is that there are many options available for the debt portion.

In the quest to grow their wealth, investors have a multitude of choices they can explore to help them work towards their goals. There is no single "best" investment choice for all investors, a well-constructed portfolio should be diversified across at least a few different types of assets and structures. While many investors are drawn to stocks because of their potential for unlimited upside, investors seeking a means of growing their wealth while avoiding the uncertainty of equities may look instead to investing in credit markets to expand their opportunity to achieve their portfolio goals.

The credit market refers to the marketplace through which companies and governments issue debt to investors in exchange for regular interest payments. Ranging from government-backed treasury bonds to more complex illiquid structures, global credit markets are massive.

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Although there exists a tremendous variety within both credit asset types and structures, all credit securities, regardless of complexity, can be boiled down to either bonds or bank loans.

Investing in Bonds

A bond is a debt investment in which an investor loans money to an entity which borrows the funds for a defined period in return for interest payments.

Typical characteristics of Bonds:

- Fixed rate coupons paid semi-annually
- Return of the full principal amount is due at maturity
- Some offer call protection, which limits the ability of the issuer to pre-pay the bonds prior to a certain period and then subject to call premiums that decline ratably each year thereafter
- Generally senior unsecured obligations of the borrower.

Investing in Bank Loans

A bank loan (or leveraged loan) is a senior secured debt instrument issued by noninvestment grade companies.

Typical characteristics of Bank Loans:

- Floating rate instrument; typically, quarterly interest payments are based on a spread to a reference rate e.g. 90-day SOFR
- Pre-payable at any time without prepayment fees; borrowers are usually also required to pre-pay a loan with excess cash flow, or if certain financial tests are not met
- Secured by collateral of the borrower, typically all tangible and intangible assets, though specific assets are often off limits
- Generally supported by financial covenants, which require borrower to maintain some minimum periodic financial performance measures, typically on a quarterly basis.

Importance of Capital Structure and Credit Ratings

Depending on an investor's portfolio goals and risk appetite, they will choose where in the capital structure to make their investment in credit. When a company is financing its overall operations or seeking growth opportunities, it will use a variety of methods to raise capital. The composition of or "structure" of a firm's liabilities is visualized in the capital structure. All securities in the investable credit marketplace are depicted, according to their risk and return profile, within the capital structure of the borrowing companies.

In addition to making a choice on where in the capital structure to invest, credit investors also have options regarding the credit rating of the borrowing company. The credit rating of the borrower has a large impact on the type of financing they can receive and how much they must pay their lenders in return. Smaller companies that are unable to issue investment grade corporate bonds are often also unable to secure inexpensive loans from major banks. Credit ratings of AAA/Aaa to BBB/Baa are considered investment grade while BB/Ba and lower are referred to as high yield. Due to the premium coupons they pay investors in return for the increased risk of default, high yield bonds play a major role in the alternative credit space.

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The Credit Marketplace is More Than Corporates and Treasuries

The credit marketplace is made up of a large variety of investment choices, differentiated by their issuers, structures, and underlying assets. Credit investing can also be further divided by marketplace. In addition to the more commonly known traded instruments shown below, there is an entire private side to credit investing outside of public companies and public markets.

U.S. GOVERNMENT TREASURIES & AGENCY BONDS	INVESTMENT GRADE CORPORATE BONDS	MUNICIPAL BONDS
Debt instruments issued and backed by the United States government or a U.S. government-sponsored agency	Bonds issued by corporations rated BBB/Baa or higher	Bonds issued by local, state, or federal governments in the United States

SOVEREIGN DEBT
Debt that is issued and backed by a national government. It is theoretically considered to be risk-free

Risks

As with any investment, there are certain risks associated with credit investing. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because credit investing can be debt investments in non-investment grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Interest rate risk is another common risk associated with credit investing. Interest rate changes will affect the amount of interest paid by a borrower in a floating rate loan, meaning they move in-step with broader interest rate fluctuations. However, this typically has little to no impact on the underlying value of floating rate debt. Conversely, interest rate fluctuations will have little to no effect on the amount of interest paid by a borrower in a fixed rate loan but will impact the underlying value of the loan if sold before maturity. Further, credit investing has exposure to default risk which makes evaluating the creditworthiness of the borrower especially critical. For these and other reasons, credit investing requires special consideration just like any other investment and may not be appropriate for all investors.

To learn more, please contact your financial professional.

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