Guide to Sub-Investment Grade/High Yield Bonds

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Investing in sub-investment grade/high yield corporate bonds can be complex and involves a variety of risks. This guide is intended to review some of the important factors to consider when investing in sub-investment grade/high yield bonds. There may be unique issues depending on your specific situation that warrant additional consideration by you and your financial, tax, or legal advisor.

What are sub-investment grade/high yield bonds?

Sub-investment grade/high yield bonds are bonds with a credit rating below investment grade (Baa3 or BBB-), as judged by the bond ratings assigned by one of the major rating agencies: Moody's Investors Service (Moody's) and Standard & Poor's. The ratings are the opinion of the agency. They are not a guarantee of credit quality, probability of default, or recommendation to buy or sell.

Bond ratings are an assessment of an issuer's ability to repay its debt, based on its history of borrowing, repayment, and other factors. Ratings reflect a current assessment of an issuer's creditworthiness and do not guarantee performance now or in the future. Issuers rated below investment grade are expected to have a greater risk of default, and therefore typically pay a higher rate of interest to investors for that risk.

Bond ratings reflect an opinion on credit quality.

	Standard & Poor's	Moody's
	Investment Grade	
Strongest/highest quality, minimal credit risk	AAA	Aaa
Strong/high quality, very low credit risk	AA	Aa
Upper medium grade, low credit risk	A	A
Moderate credit risk	BBB	Baa
	Sub-Investment Grade/High Yield	
Speculative grade, higher credit risk	BB, B	Ba, B
Highly speculative, very high credit risk	CCC, CC, C	Caa, Ca
Default	D	C
Not rated or not available	NR or NA	NR or NA
Rating withdrawn	WD	WD

Note: Standard & Poor's ratings from A to CCC may be modified by a plus (+) or minus (-) sign to show relative standing within the rating categories. Moody's uses numerical modifiers 1, 2, and 3 in each category: The modifier 1 indicates that the obligation falls in the higher end of its category; the modifier 2 indicates a mid-range assessment; and the modifier 3 indicates a standing in the lower end of that rating category.

Source: Standard & Poor's and Moody's.

Why invest in sub-investment grade/high yield bonds?

The primary and most common reason that investors choose to invest in sub-investment grade/high yield bonds is to try to **enhance income**. The yields on these bonds are generally higher than yields available in higher-quality U.S.-government or investment grade corporate bonds.

Another possible reason that investors choose to invest in sub-investment grade/high yield bonds is for **portfolio diversification**. Investors with greater risk tolerance may choose to diversify a portion of their fixed income portfolio into sub-investment grade/high yield bonds in order to get exposure to a different risk/return profile. For example, sub-investment grade/high yield bonds tend to be less sensitive to changes in Treasury yields than investment grade corporate bonds. However, they can also be more sensitive to economic conditions—both negatively during deteriorating conditions and positively during improving conditions.

Lastly, investors may choose to invest in sub-investment grade/high yield bonds for possible **capital appreciation**. Sub-investment grade/high yield bonds can experience dramatic price fluctuations depending on market and issuer conditions. Investors with a high risk tolerance may choose to speculate on these price-driven returns by buying and selling sub-investment grade/high yield bonds.

What are the risks of sub-investment grade/high yield bonds?

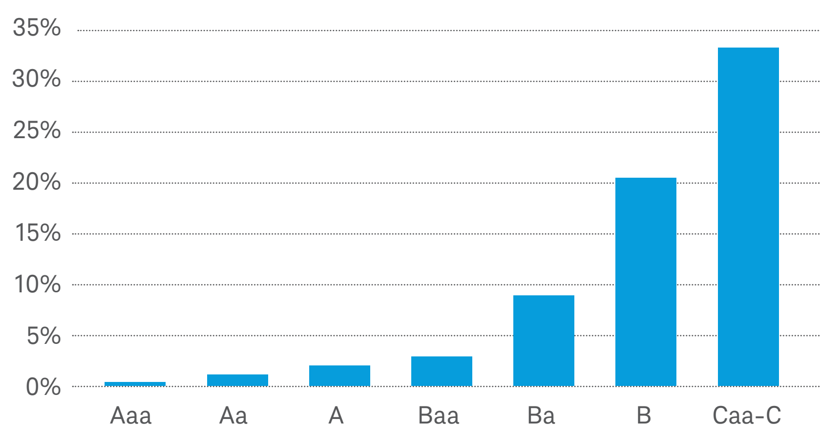
While sub-investment grade bonds generally provide higher yields than investment grade bonds, there are increased risks associated with these securities that you should be aware of before deciding whether to invest. It's easy to be tempted by higher yields and strong returns; however, most investors should only consider sub-investment grade/high yield bonds in moderation as support for, not the core of, a well-diversified fixed income portfolio. Understanding these risks is important to your ability to select the appropriate types of fixed income investments and construct a portfolio to meet your goals.

Credit risk

Credit risk is the possibility that a bond's issuer will be unable to make interest payments or return principal at maturity as promised. Credit risk comes in two primary forms that can each affect the value of a security. To understand the implications of credit risk, you must consider the risk of default and credit downgrade:

- **Default risk**—Default occurs when an issuer no longer makes bond interest payments and/or no longer pays back principal in a timely manner. Default can also be triggered by violations of financial or other covenants in the bond indenture. This may lead to bankruptcy or reorganization in corporate issuers. As illustrated in the chart below, sub-investment grade/high yield bonds have historically experienced a substantially higher rate of default compared to investment grade bonds.

Cumulative Five-Year Average Default Rate



Source: Moody's Investors Services, "Annual Corporate Default Study: Corporate Default and Recovery Rates, 1920-2015." The default rates shown are the average cumulative issuer-weighted global default rate, using data from 1920 through 2015.

- **Downgrade risk**—This is the risk that a credit rating agency lowers its rating on the bond or issuer. Even without default, a rating downgrade or other credit event—such as being placed on credit watch, reorganizations, or legal proceedings—can result in a fall in price before maturity. For example, bonds may go on a negative credit watch before being downgraded as a signal to the market that a downgrade might be coming. When the market fears a bond might be downgraded, the price may start to fall. Even without a downgrade, the price of an individual bond in the open market may decline if business conditions or performance for the issuer change. Bond rating agencies are not predictors of credit quality, and can often react slowly to changing credit events, meaning that a sub-investment grade/high yield bond's price may decline prior to a rating agency placing the bond on review for downgrade.

Interest rate, economic, and market risks

It's widely known that the prices of outstanding bonds typically move in the opposite direction of interest rates. All else being equal, when interest rates rise, the prices of bonds fall; and when rates fall, prices rise. However, the higher income payments that high yield bonds offer decreases their sensitivity to rising rates, and over time can help offset potential price declines.

Generally, the economic prospects of issuers of sub-investment grade/high yield bonds tend to be better when economic conditions are improving and worse when those conditions weaken. If the economic prospects of an issuer are deteriorating, that may negatively impact the market's view of the issuer's creditworthiness and, therefore, the prices of their bonds. While this can also be said for investment grade issuers, the effects tend to be more pronounced for issuers of sub-investment grade/high yield bonds.

Also, during extreme market uncertainty, investors often flock to investments that are considered to be safe (such as U.S. Treasury securities), resulting in what's known as a "flight to quality." This overall movement by market participants out of riskier assets and into safer assets can also have a negative impact on the prices of sub-investment grade/high yield bonds relative to investment grade bonds. This disproportionately negative impact was seen in 2008, when sub-investment grade/high yield bonds dropped more than 25% in value (along with a 37% drop in the S&P 500®) versus a 5% drop in investment grade corporate bonds.[1]

Liquidity risk

Liquidity is the measure of how easily you can sell a security without incurring high transaction costs or a reduction in price. Investors encounter liquidity risk when they are forced to sell a security before maturity and find that the amount they receive for their security is significantly less than the amount that they would have to pay to purchase the same security at the same point in time.

Liquidity is measured in terms of the bid-ask spread—the price difference between what someone is willing to pay for the security (bid) and what they are willing to sell the security for (ask). The market for sub-investment grade/high yield bonds is generally less liquid than for investment grade bonds because issue sizes tend to be smaller and buyers may be unwilling to bid on bonds with increased risk. As a result, the bid-ask spread is typically much wider for sub-investment grade/high yield bonds.

Corporate bonds with higher ratings are generally more liquid than those with lower ratings. This is an important and often under-appreciated aspect of investing in sub-investment grade/high yield bonds. Bond dealers may offer a lower price for a less desirable security, such as one that is having credit problems. If you have to sell early, the price may be lower than you originally paid, or lower than what might otherwise be expected, because there are few potential buyers.

What are some ways to help manage risk?

Due to the increased risks associated with sub-investment grade/high yield bonds, it's important that investors consider a number of factors to help manage that risk.

First, **consider diversifying across issuers and sectors**. Diversification limits exposure to any single bond issuer that may have problems making timely interest and principal payments. In addition to diversifying by issuer, corporate bonds are categorized in three broad industry sectors—financial, industrial, and utility. Investors should consider an appropriate mix across these sectors.

While more aggressive investors may choose to invest in sub-investment grade/high yield bonds and are comfortable with the risks involved, the Schwab Center for Financial Research suggests that investors **consider limiting their allocation to no more than 20% of their fixed income portfolio** inclusive of other higher-risk fixed income sub-asset classes, such as preferred stocks and emerging market bonds.

Additionally, individual investors should generally **consider using a diversified mutual fund or exchange-traded fund** to benefit from professional management as well as to limit exposure to any single issuer. Bond funds can also be more liquid and cost-effective than a portfolio of individual bonds. However, it's important to know that bond funds do not promise a return of principal on a specific maturity date like individual bonds, and income payments and principal values can fluctuate. Also, bond funds may offer investors less transparency and control than individual bonds, be less tax-efficient, and be subject to trading limitations.

Diversification is important, as is the ability to assess **long-term credit quality** when investing in sub-investment grade/high yield bonds. As a tool to help clients with these assessments, Schwab provides Moody's Investors Service Credit Rating Reports on Schwab.com. To view a ratings report from Moody's (when available), click the Moody's credit rating on either the Search Results page or the Positions page to access reports.

How are Schwab registered representatives compensated for sub-investment grade/high yield bonds?

Investment professionals at Schwab are compensated based on a number of different components. For detailed information on how Schwab investment professionals, including Fixed Income Specialists, are compensated, see Compensation and Advice Disclosures.[2]

Do sub-investment grade/high yield bonds make sense for you?

Sub-investment grade/high yield bonds may provide potential benefits to investors who understand the risks. This guide highlights some of the factors to consider before investing.

For further assistance in understanding sub-investment grade/high yield bonds or placing orders, please contact a Charles Schwab Fixed Income Specialist at **1-800-626-4600** between 8:30 a.m. and 6:00 p.m. ET.

For additional information about sub-investment grade/high yield bonds, visit the following websites:

Financial Industry Regulatory Authority (FINRA): finra.org

U.S. Securities and Exchange Commission: sec.gov

Securities Industry and Financial Markets Association (SIFMA): investinginbonds.com

[1]In this discussion, we refer to the annualized total returns for 2008 provided by Morningstar, Inc. Sub-investment grade/high yield returns are represented by the Barclays U.S. Corporate High Yield Bond Index, and investment grade corporate bond returns are represented by the Barclays U.S. Corporate Investment Grade Index.

S&P 500® Index is a market-capitalization-weighted index that consists of 500 widely traded stocks chosen for market size, liquidity, and industry group representation.

Barclays U.S. Corporate High Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Barclays U.S. Corporate Bond Index covers the U.S. dollar-denominated investment grade, fixed-rate, taxable corporate bond market. Securities are included if rated investment grade (Baa3/BBB-/BBB- or higher) using the middle rating of Moody's, S&P, and Fitch. This index is part of the Barclays U.S. Aggregate Bond Index.

[2]Please call 1-800-626-4600 between 8:30 a.m. and 6:00 p.m. ET to learn more or to request a printed copy.

Important Disclosures

Investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges, and expenses. You can request a prospectus by calling Schwab at 1-800-435-4000. Please read the prospectus carefully before investing.

Investment value and return will fluctuate such that shares, when redeemed, may be worth more or less than original cost.

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Fixed income investments are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, corporate events, tax ramifications, and other factors.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

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 CC1188817 (0317-W1LJ) MKT65103-02 (05/17)
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