HIGH-YIELD CORPORATE BONDS EXPLAINED

1. High-Yield Corporate Bonds

1.1 The basics

A high-yield corporate bond is basically a loan made to a corporation issuing a debt security. The purchasers can be a single investor or a number of investors, also referred to as bondholders. The corporation receiving the loan is known as the issuer. The terms or conditions of principal and interest payments are known as the bond's indenture.

A number of factors distinguish high-yield corporate bonds from investment-grade corporate bonds. The most obvious is the debt security's ranking or position along the credit scale. Since the issuer's debt level and track record play into the probability of timely payment and repayment as defined in the indenture, the issuer's financial stability or credit is a critical factor to consider before purchasing a bond. Providing a gauge of this financial stability, a credit rating evaluates the credit worthiness of the issuer. The rating is an evaluation made by a credit rating agency that ranks the issuer's ability to meet its financial obligations. The rankings cover the most financially sound companies down to the weakest, and range from the strongest rating of 'AAA' down to 'D' for "in-default."

The dividing line between investment-grade corporate and high-yield bonds is just below the lower-medium-grade rating of 'BBB-'. Bonds with ratings lower than 'BBB-' are considered non-investment-grade, or high yield ('BBB-' by Standard & Poor's, or equivalently, 'Baa2' by Moody's and 'BBB-' by Fitch). These lower tiers of credit ratings suggest a higher chance of an issuer default, where the company does not pay coupon interest or the principal amount due at maturity as required by the bond's indenture. Because of the risks attached to late or non-payment, these companies offer a higher interest rate of return or additional benefits to the indenture in order to compensate investors for assuming the additional risk.

1.2 Who issues high-yield corporate bonds?

The pool of high-yield debt issuers is diverse. The companies come from a number of industries (media, entertainment, gaming, manufacturing, energy, technology, etc.), and use the funds in various ways. Some high-yield bonds started off as investment-grade debt, but through economic or business events have been become "fallen angels." Start-up companies are new to the capital markets and will have a need for seed capital. Established companies whose line of business is capital-intensive will require funds in order to start new projects. The borrowed capital can also be used in reorganizing a company recovering from bankruptcy or a leveraged buyout. In all cases, the bonds offer a higher reward in return for the additional risk involved.

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A number of high-yield bond deals are not registered with the SEC (Securities Exchange Commission). Instead, deals come to market under the exception of Rule 144A. Rule 144A is an amendment to the Securities Act of 1933, which provides some exemptions from registration requirements. As part of the rule, brokers and dealers are required to document that an investor is a QIB (Qualified Institutional Buyer) who owns at least USD 100 million in investable assets.

Rule 144A has provided some safety to non-U.S. companies and high-yield issuers accessing the U.S. capital markets. Under 144A, securities can be issued "with" or "without" registration rights. The former applies if a company will eventually register with the SEC at a future date, while the latter means the security will remain unregistered for the life of the bond. Deals with registration rights are often exchanged for an identical series of bond once the paperwork for SEC registration has been completed. The benefit to registration is that the issue will be more available to investors and thus have more liquidity.

1.3 High-yield bond coupon types

As their name suggests, high-yield bonds return a higher coupon rate than more traditional investments. Coupons are usually fixed-rate, and most bonds pay the coupon on a semiannual basis. Zero-coupon bonds are generally sold at a steep discount to face value by issuers who may not have the cash flow to pay interest. These issuers may be start-up businesses or ventures that require the completion of a project before revenue is achieved. In these cases, investor return comes in the form of capital appreciation, rather than interest payments.

Another type of coupon found among high-yield bond offerings is floating-rate, in which the rate is spread to a benchmark interest rate and is revised on a periodic basis. Step-ups, floaters and toggle notes are all types of high-yield bonds that offer coupons whose levels of interest change over time.

A coupon may also pay "in-kind," or in the form of additional bonds rather than cash. These deals, known as "PIK" notes, give the issuer additional time before any cash outlay. PIKs allow a company to borrow more money without requiring immediate cash flow to maintain the debt. Thus, PIKs are viewed as more speculative debt securities.

1.4 High-yield bond structures

High-yield bonds range in both maturity and term structure. Terms will depend on the type of issuer and their financial position or line of business. More highly speculative companies might set a higher coupon to attract buyers, but shorten the maturity to allow for quicker refinancing. Bonds can be bullet or straight up, callable, putable and even exchangeable, depending on the terms stated in the indenture. A number of widely used structures are mentioned below and defined in the glossary at the end of this document:

- Bullet bond
- Callable bond
- Put bond
- Make-whole call
- Equity warrant
- Escrow
- Clawback

1.5 ETFs can provide access to high yield

The exchange traded fund (ETF) has made investing in fixed income more efficient. Combining the structure of a mutual fund and the characteristics of an individual stock, ETFs are portfolios of securities that track specific indices. Like stocks, they can be bought and sold on an exchange and are quoted continuously throughout the day. They provide liquidity and diversification to a product sector, in addition to transparency and cost savings. Through ETFs, high-yield debt is now more accessible as an investment choice to investors who either do not qualify as a QIB or prefer not to be tied to the requirements of a mutual fund.

2. S&P U.S. Issued High Yield Corporate Bond Index

2.1 About the index

The S&P U.S. Issued High Yield Corporate Bond Index (ticker: SPUSCHY) comprises a universe of high-yield corporate bonds issued by U.S.-domiciled corporations denominated in U.S. dollars. The indices in this index series are used extensively by institutional investment managers, mutual fund managers and professional advisors.

2.2 Constituent selection

To be selected as constituents of the index, bonds must meet the following criteria:

Currency. Must be issued in U.S. dollars.

Country. The issuer's country of incorporation must be the U.S.

Maturity. Each bond must have a maturity greater than or equal to one month from the rebalancing date. No bonds mature in the index.

Rating. The maximum credit rating for inclusion in high-yield indices is 'BB+'/'Ba1'/'BB+' by Standard & Poor's, Moody's or Fitch, respectively. For an issue rated by S&P, Moody's and Fitch, the lowest of the three ratings is used as the issue's credit rating. When there are two ratings, the lower of the two is considered. When there is only one rating, that rating must be considered below investment grade. New issues must be rated by at least one rating agency to be considered at the next rebalancing. Bonds that are not rated are removed at the first rebalancing. For ratings-based subindices, the above rules are applied to the appropriate rating band.

Pricing. Daily pricing is provided by Interactive Date Corporation (IDC).

Coupon. Bonds must have a fixed coupon schedule.

Debt Seniority. Senior and subordinated bonds are included. Covered bonds and equipment trust certificates are excluded. Non-corporate bonds secured by mortgages are also excluded.

Bond Type. The following corporate structures are included: debentures, medium-term notes, zero-coupon bonds, corporate PIK bonds, and corporate-insured bank notes are eligible. Capital securities (hybrid capital) are eligible during their fixed-rate term and exit the index one month prior to their conversion to floating-coupon securities. Perpetual bonds are included. Fixed-to-float bonds must have a fixed rate period greater than or equal to one month as of the rebalancing date to be considered.

Optionality. Callable/putable bonds are included.

Market of Issue. Corporate debt must be publicly issued in the U.S. domestic market as SEC-registered or 144A securities.

Size. A minimum par of USD 100 million at each rebalancing is required.

Monthly Rebalance. The members of the index are reviewed and rebalanced on a monthly basis.

2.3 Index characteristics

The index does not have a set number of constituents. Rather, the number of constituents is based on how many issues are eligible at each rebalancing.

Index Characteristics	
Index name	S&P U.S. Issued High Yield Corporate Bond Index
Ticker	SPUSCHY
Constituent count	2111
Par amount outstanding (USD)	1,100,789,391,000
Market value (USD)	1,144,201,706,760.39
Price (USD)	101.608
Years to maturity	6.787
Coupon	7.391
Yield to maturity	6.652
Yield to worst	6.390
Modified duration	4.877
Effective duration	4.586
Convexity	0.001
Option-adjusted spread	482.868

Source: S&P Dow Jones Indices. Data as of June 24, 2013.

2.4 Index data

S&P U.S. High Yield Corporate Bond Index levels are available through the S&P Dow Jones Indices website at **www.spdji.com**. Information is also provided through major quote vendors, numerous investment-oriented websites, and various print and electronic media.

2.5 Data packages

All U.S. high-yield corporate index data is available from S&P Dow Jones Indices via a daily FTP (File Transfer Protocol) delivery link.

Index Name	Index Code
S&P U.S. Issued High Yield Corporate Bond Index	SPUSCHY
S&P U.S. Issued BB High Yield Corporate Bond Index	SPUSH2BT
S&P U.S. Issued B High Yield Corporate Bond Index	SPUSH1BT
S&P U.S. Issued CCC & Lower High Yield Corporate Bond Index	SPUSC3BT
S&P U.S. Issued Large Cap CCC & Above High Yield Corporate Bond Index	SPUSCLC

3. Glossary

Term	Definition
Bond**	Bonds are debt securities issued by corporations and governments. They are loans that investors make to issuers in return for the promise of being paid interest, usually but not always at a fixed rate, over the long term. The issuer also promises to repay the loan principal at maturity, on time and in full.
Bullet Bond*	A debt instrument whose entire face value is paid at once on the maturity date. Bullet bonds are non-callable. They cannot be redeemed early by an issuer, so they pay a relatively low rate of interest because of the issuer's exposure to interest-rate risk. Both corporations and governments issue bullet bonds, and bullet bonds come in a variety of maturities, from short- to long-term. A portfolio made up of bullet bonds is called a bullet portfolio.
Callable Bond**	A callable bond can be redeemed by the issuer before it matures if that provision is included in the terms of the bond agreement, or deed of trust.
Clawback*	Money or benefits that are distributed and then taken back as a result of special circumstances.
Coupon**	Bonds with coupons are also known as bearer bonds because the bearer of the coupon is entitled to the interest. The term “coupon” is a synonym for interest in phrases like “coupon rate.”
Equity Warrant**	Corporations may issue warrants that allow you to buy a company’s stock at a fixed price during a specific period of time, often 10 or 15 years, though sometimes there is no expiration date. Warrants are generally issued as an incentive to investors to accept bonds or preferred stocks that will be paying a lower rate of interest or dividends than would otherwise be paid.
Escrow**	When someone else holds assets of yours until the terms of a contract or an agreement are fulfilled, your assets are said to be held in escrow. The assets could be money, securities, real estate or a deed. The person or organization that holds the assets is the escrow agent, and the account in which they are held is an escrow account.
Exchange Traded Fund (ETF)**	Exchange traded funds (ETFs) are listed on a stock exchange and trade like a stock. You can use traditional stock trading techniques, such as stop orders, limit orders, margin purchases and short sales when you buy or sell ETFs.
Fallen Angel**	Corporate or municipal bonds that were investment-grade when they were issued but have been downgraded are called fallen angels. Bonds are downgraded buy a rating service, such as Moody’s Investors Service or Standard & Poor’s Ratings Services.
Floating Rate**	A debt security or corporate preferred stock whose interest rate is adjusted periodically to reflect changing money market rates is known as a floating rate instrument. These securities, for example five-year notes, are initially offered with an interest rate that is slightly below the rate being paid on comparable fixed-rate securities.
High-Yield Bond**	High-yield bonds are bonds whose ratings from independent rating services are below investment grade.
Indenture**	An indenture is a written contract between a bond issuer and bondholder that is proof of the bond issuer’s indebtedness and specifies the terms of the arrangement, including the maturity date, the interest rate, whether the bond is convertible to common stock, and, if so, the price or ratio of the conversion.
Investment Grade**	When a bond is rated investment grade, its issuer is considered able to meet its obligations, exposing bondholders to minimal default risk.
Issuer**	An issuer is a corporation, government, agency or investment trust that sells securities, such as stocks and bonds, to investors.
Make-Whole Call (Provision)*	A type of call provision on a bond allowing the borrower to pay off remaining debt early. The borrower has to make a lump sum payment derived from a formula based on the net present value (NPV) of future coupon payments that will not be paid because of the call.
Pay-in-Kind (PIK)*	A financial instrument that pays interest or dividends to investors of bonds, notes or preferred stock with additional debt or equity instead of cash. Payment-in-kind securities are attractive to companies who would prefer not to make cash outlays. They are often used in leveraged buyouts.
Put Bond*	A bond that allows the holder to force the issuer to repurchase the security at specified dates before maturity. The repurchase price is set at the time of issue, and is usually par value.
Qualified Institutional Buyer (QIB)*	A corporate entity that falls within the "accredited investor" category, defined in SEC Rule 501 of Regulation D. A Qualified Institutional Buyer (QIB) is one that owns and invests, on a discretionary basis, at least USD 100 million in securities; for a broker-dealer the threshold is USD 10 million. QIBs encompass a wide range of entities, including banks, savings and loans associations, insurance companies, investment companies, employee benefit plans or entities owned entirely by accredited investors. Banks and S&L associations must also have a net worth of at least USD 25 million to satisfy the QIB criteria.

Term	Definition
Step-up Bond*	A bond that pays an initial coupon rate for the first period, and then a higher coupon rate for the following periods. A step-up bond is one in which subsequent future coupon payments are received at a higher, predetermined amount than previous or current periods. These bonds are often purchased by individuals or portfolio managers who wish to hold fixed income securities with similar features to TIPS, but with a higher coupon.
Toggle Notes*	A payment-in-kind bond, where the issuer has the option to defer an interest payment by agreeing to pay an increased coupon in the future. With toggle notes, all deferred payments must be settled by the bond's maturity.
Zero-Coupon Bond**	Zero-coupon bonds, sometimes known as zeros, are issued at a deep discount to par value and make no interest payments during their term.

*Source: Investopedia US, A Division of ValueClick, Inc., 2013.
**Source: Virginia B. Morris and Kenneth B. Morris, Standard & Poor's Dictionary of Financial Terms, Lightbulb Press, Inc., 2007.

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