



SEC

OFFICE of INVESTOR
EDUCATION and ADVOCACY

INVESTOR BULLETIN

What Are High-yield Corporate Bonds?

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate individual investors about high-yield corporate bonds, also called "junk bonds." While they generally offer a higher yield than investment-grade bonds, high-yield bonds also carry a higher risk of default.

What is a high-yield corporate bond?

A *high-yield corporate bond* is a type of [corporate bond](#) that offers a higher rate of interest because of its higher risk of default. When companies with a greater estimated default risk issue bonds, they may be unable to obtain an investment-grade bond credit rating. As a result, they typically issue bonds with higher interest rates in order to entice investors and compensate them for this higher risk.

High-yield bond issuers may be companies characterized as highly leveraged or those experiencing financial difficulties. Smaller or emerging companies may also have to issue high-yield bonds to offset unproven operating histories or because their financial plans may be considered speculative or risky.

What are some key risks in high-yield corporate bonds?

Some investors with a greater risk tolerance may find high-yield corporate bonds attractive, particularly in low interest rate environments. If you are considering buying

a high-yield bond, it is important that you understand the risks involved.

Default risk. Also referred to as credit risk, this is the risk that a company will fail to make timely interest or principal payments and default on its bond. Defaults also can occur if the company fails to meet certain terms of its debt agreement. Because high-yield bonds are typically issued by companies with higher risks of default, this risk is particularly important to consider when investing in high-yield bonds.

Interest rate risk. Market interest rates have a major impact on bond investments. The price of a bond moves in the opposite direction than market interest rates—like opposing ends of a seesaw. This presents investors with interest rate risk, which is common to all bonds. In addition, the longer the bond's maturity, the more time there is for rates to change and, as a result, affect the price of the bond. Therefore, bonds with longer maturities generally present greater interest rate risk than bonds of similar credit quality that have shorter maturities.

Economic risk. If the economy falters, some investors are likely to try to sell their bonds. In what is known as a "flight to quality," a number of investors may decide to replace their riskier high-yield bonds with safer ones, such as U.S. Treasury bonds. If there are more sellers

than buyers for high-yield bonds, the supply will exceed demand and prices of the bonds will fall. In addition, some companies that issue high-yield bonds may be less able to weather challenging economic circumstances, increasing the risk of default.

Liquidity risk. Liquidity is the ability to sell an asset, such as a bond, for cash when the owner chooses. Bonds that are traded frequently and at high volumes may have stronger liquidity than bonds that trade less frequently. Liquidity risk is the risk that investors seeking to sell their bonds may not receive a price that reflects the true value of the bonds (based on the bond's interest rate and creditworthiness of the company). High-yield bonds may be subject to more liquidity risk than, for example, investment-grade bonds.

How can you invest in high-yield corporate bonds?

You can invest directly in high-yield corporate bonds by buying them from broker-dealers. Alternatively, you can invest in these high-yield bonds indirectly by buying shares in [mutual funds](#) or [exchange-traded funds \(ETFs\)](#) with a high-yield bond focus. These mutual funds and ETFs have portfolios that contain high-yield bonds. The investment adviser of the mutual fund or ETF selects the high-yield bonds for the portfolio.

Special Note for Owners of High-Yield Bond Mutual Funds or ETFs

Investors in high-yield bond mutual funds or ETFs are not immune from liquidity and other risks. If many bond fund investors cash out their shares at the same time, the fund may need to sell assets to raise cash to pay for the redemptions. This may force the fund to sell bonds at a loss, causing the fund's share price to fall.

What should I research before investing?

While useful information may be found in a variety of secondary sources, you should be sure to read primary offering documents, such as the prospectus. A prospectus is an offering document filed with the SEC by a company, mutual fund, or ETF when it registers securities it intends to sell to the public.

Among other things, the prospectus for a corporate bond offering describes the offering, the financial condition of the company issuing the bond, how the company plans to use the proceeds from the sale of the bonds, the terms of the bond, and the significant risks of investing in it.

Prospectuses for registered corporate bond offerings are available to the public without charge on the SEC's [EDGAR](#) website, available at www.sec.gov/edgar/searchedgar/webusers.htm.

Be sure to understand the terms of the offering, which could include any of the following:

- **Covenant protections.** Covenants are terms designed to protect bondholders by restricting the company from taking actions that could negatively affect its ability to pay principal and interest. Covenants can also protect the bondholders' claim of priority over other creditors. For example, covenants could restrict the company's ability to pay shareholder dividends or limit it from taking on more debt. Covenant protections are often more extensive, and may take on greater importance, for high-yield bonds because they generally present a higher risk of default. Nonetheless, when high-yield bonds are in strong demand, some companies may include fewer covenant protections. Investors should consider the additional risks of investing in "covenant-lite" bonds. You should not hesitate to ask your broker or other financial professional about the covenant protections of any bond you are considering purchasing.

- **Payment terms.** Some bonds may allow the issuer to skip an interest payment under certain conditions. The terms also may allow payment-in-kind, or PIK, which means that an interest payment may come in the form of additional bonds rather than cash. Before purchasing a bond, investors should make sure they understand and are comfortable with the terms of payment. Similarly, investors in a high-yield bond mutual fund or ETF should understand whether the fund or ETF may invest in bonds with such payment terms.
- **Call provisions.** These provisions allow the company to “call” the debt or, in other words, repay the bond in full before it matures. The bond terms will specify whether and when the company may call the bond. For example, a bond with a 10-year maturity may have call protection for the first five years, during which the company cannot call the bond. But the company could call the bond any time in the final five years. If the bond is called during the period after the call protection has elapsed, investors will receive their principal back, but may be unable to reinvest it at a similar rate of interest. Before investing in a bond, investors should understand the call terms along with any other provisions that could result in early payment.

Bond fund prospectuses. If you are investing in a high-yield bond-focused mutual fund or ETF, these funds also prepare prospectuses detailing important information about the fund. In addition to [EDGAR](#), you can also find a bond fund’s prospectus at the bond fund’s website.

Conclusion

You should base your decision to invest in high-yield bonds on your individual circumstances, including your income and net worth, investment objectives, risk tolerance, time horizon and other security holdings. In addition, you should have a good understanding of both the potential rewards and the risks involved.