From Zeros to Heroes? The recent rise in rates has created a universe of deeply discounted bonds. We assess ways to utilize these securities.

- High-rated corporate bond issues from earlier this year offer such relatively low coupons that they share some characteristics with zero-coupon bonds.

- While not a solution to all investors’ needs, these deeply discounted bonds can be attractive for certain types of strategies, which we discuss below.

With the recent rise in Treasury rates, high-rated corporate bonds that were issued only a few months ago are now trading at steep discounts to par. The best examples are the 10- and 30-year bonds issued at or near par by tech giants Apple (Aa1/AA+/NR) and Microsoft (Aaa/AAA/AA+) at the end of April 2013. Apple’s 2.40% 2023 and Microsoft’s 2.375% 2023 currently trade in the low 90s to high 80s context, whereas Apple’s 3.85% 2043 and Microsoft’s 3.75% 2043 trade in the mid to low 80s range. This drastic shift stems from the 100 basis point move in Treasury rates in anticipation of the Fed tapering its bond-buying strategy. Since these and other high-rated low-coupon bonds have dropped in value so significantly as of late, they share certain traits of zero-coupon bonds. As true zeros are in short supply in the corporate space, deeply discounted bonds represent an alternative.

A Quick Primer on Zeros

Zero-coupon bonds offer no additional payment to the bondholder beyond the return of principal at maturity. Instead, to compensate the bondholder, these bonds trade at a steep discount to par from the start. Over time, the bonds accrete towards par as they approach maturity. The difference between the maturity value and purchase price is the yield.

Because zeros offer no interest payments prior to maturity, the bonds have the highest level of exposure to interest rate risk. Duration, which measures how a change in interest rates will affect the value of the bond, is equal to the years to maturity for zero-coupon bonds, whereas coupon bonds have duration below maturity, meaning that a movement in interest rates will result in a larger move in zeros versus coupon bonds. At the same time, zeros eliminate reinvestment risk, the risk of finding a security that offers the same yield-to-maturity as the security the investor already owns. Like coupon bonds, zeros have a certain amount of credit risk, issuer dependent, in that the change in credit quality of the issuer could affect the value of the bond.

Deeply Discounted Bonds

When discussing “deeply discounted bonds,” we are referring to those corporate bonds offered by high-rated corporate issuers which offer such below-market coupon rates, that the securities trade well below par value. In some sense, these securities can trade almost as if they do not offer any additional coupon payments like zero-coupon bonds. Note that we exclude from this definition bonds that are nearing default, which could explain the deep discount.

Below we compare Apple’s deeply discounted 30-year bond with Wal-Mart’s above-market coupon 30-year bond and 30-year US Treasury’s STRIPS (zero-coupon bonds). While these three bonds are not perfectly comparable, we can draw enough comparisons to make a compelling argument for looking at deeply discounted bonds over alternatives.
Deeply discounted bonds can be attractive for long-term investment strategies with specific timing needs, such as higher education or retirement planning.

### How to Utilize Deeply Discounted Bonds for Investing

Deeply discounted bonds can be attractive for investors wanting to purchase bonds from high quality corporate issuers for a long-term investment strategy and to fill the corporate zeros void. While firms have issued corporate zeros since the early 1980s, as of August 2013, only $4.8B in corporate zeros across 12 securities remained outstanding. Deeply discounted bonds can, therefore, stand in as a proxy with less exposure to interest rates than zeros.

Deeply discounted bonds can be attractive for long-term investment strategies with specific timing needs, such as higher education or retirement planning. The fact that deeply discounted bonds trade well below their par value allows investors planning for a long-term investment horizon to put smaller amounts away now and receive a larger amount (plus some cash flows along the way) when the securities mature. These bonds allow investors to manage long-term investment horizons through an expected fixed amount of cash flows. Additionally, as compared to par bonds, taxes on long-term deeply discounted bonds can be smaller on a present value basis (assuming both mature at par), as a portion of tax requirements are held up in principal, which investors can elect not to report until the bonds mature.* Other ways to use deeply discounted bonds in lieu of zeros include creating a portfolio of synthetic par bonds. We discuss this concept further in a note from fall 2012 found here.

### Conclusion

While there are a few corporate bond zeros outstanding currently, the recent movement in rates has caused many high-quality low-coupon bonds to fall more into the realm of zero-coupon bonds. These bonds can be used in a similar investing strategy as traditional zero-coupon bonds, but discount bonds have decreased volatility towards interest rate changes over zero-coupon bonds. Additionally, there may be added benefits to owning these securities, as a portion of the gains on these securities would not be taxed until the bondholder closes the position.

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*(1) Including zero-coupon bonds with the following criteria: greater than $100MM outstanding, not RegS or 144A, US-based company, USD-denominated, and investment grade by Moody’s or S&P. *Consult your tax advisor for additional details about potential tax implications.
As true zeros are in short supply in the corporate space, deeply discounted bonds represent an alternative.

<table>
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<tr>
<th>Cusip</th>
<th>Issuer</th>
<th>Amt Outs ($MM)</th>
<th>Cpn</th>
<th>Mty</th>
<th>Mod Duration</th>
<th>Ratings</th>
<th>MR Price</th>
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<td>APPLE INC</td>
<td>5,500</td>
<td>2.40%</td>
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<td>8.3</td>
<td>Aa1/AA+/NR</td>
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<td>May-23</td>
<td>7.9</td>
<td>A3 /*-/-A/-A</td>
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Source: Janney FISR; Company Reports; FINRA TRACE; only shows single A rated or greater bonds with $1B in issuance size sorted first by amount outstanding and then by average 30-day trading volume.
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How to Utilize for Investing

Conclusion

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Janney FIS Outlooks Distribution as of 09/16/2013

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Benchmarks

Asset Classes: Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark. Treasuries: Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark. Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark. Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark. High Yield Credit: Janney FIS ratings employ the "Barclay's U.S. Corporate High Yield Index" as a benchmark. Municipal: Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

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