Junk Bonds: Everything You Need To Know

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For many investors, the term "junk bond" evokes thoughts of investment scams and high-flying financiers of the 1980s, such as Ivan Boesky and Michael Milken, who were known as "junk bond kings". But don't let the term fool you - if you own a bond fund, these worthless-sounding investments may have already found their way into your portfolio. Here's what you need to know about junk bonds. (For more, read our *Bond Basics Tutorial*.)

What Is a Junk Bond?

From a technical point of view, a junk bond is exactly the same as a regular bond. Junk bonds are an IOU from a corporation or organization that states the amount it will pay you back (principal), the date it will pay you back (maturity date) and the interest (coupon) it will pay you on the borrowed money.

Junk bonds differ because of the credit quality of their issuers. All bonds are characterized according to this credit quality and therefore fall into one of two categories of bonds:

- **Investment Grade** - These are bonds are issued by low- to medium-risk lenders. A bond rating on investment grade debt usually ranges from 'AAA' to 'BBB'. Investment grade bonds might not offer huge returns, but the risk of the borrower defaulting on interest payments is much smaller.
- **Junk Bonds** - These are the bonds that pay high yields to bondholders because the borrowers don't have any other option. Their credit ratings are less than pristine, making it difficult for them to acquire capital at an inexpensive cost. Junk bonds are typically rated at 'BB'/'Ba' or less.

Think of a bond rating as the report card for a company's credit rating. Blue-chip firms that provide a safer investment have a high rating, while risky companies have a low rating. The chart below illustrates the different bond rating scales from the two major rating agencies, Moody's and Standard and Poor's:

Bond Rating

Moody's	Standard & Poor's	Grade	Risk
Aaa	AAA	Investment	Lowest Risk
Aa	AA	Investment	Low Risk
A	A	Investment	Low Risk

Baa	BBB	Investment	Medium Risk
Ba, B	BB, B	Junk	High Risk
Caa/Ca/C	CCC/CC/C	Junk	Highest Risk
C	D	Junk	In Default

Although junk bonds pay high yields, they also carry higher-than-average risk that the company will default on the bond. Historically, average yields on junk bonds have been between 4-6% above those on comparable U.S. Treasuries. (For related reading, see *High Yield, Or Just High Risk?*)

Junk bonds can be broken down into two other categories:

- **Fallen Angels** - This is a bond that was once investment grade but has since been reduced to junk bond status because of the issuing company's poor credit quality.
- **Rising Stars** - The opposite of a fallen angel, this is a bond with a rating that has been increased because of the issuing company's improving credit quality. A rising star may still be a junk bond, but it's on its way to being investment quality.

Who Should Buy Junk Bonds?

There are a few things you should know before you run out and tell your broker to buy all the junk bonds he can get a hold of. The obvious caveat is that junk bonds are high risk. With this type of bond, you risk the chance that you will never get your money back. Secondly, investing in junk bonds requires a high degree of analytical skills, particularly knowledge of specialized credit. Short and sweet, investing directly in junk is mainly for rich and motivated individuals. This market is overwhelmingly dominated by institutional investors.

This isn't to say that junk-bond investing is strictly for the wealthy. For many individual investors, using a high-yield bond fund makes a lot of sense. Not only do these funds allow you to take advantage of professionals who spend their entire day researching junk bonds, but these funds also lower your risk by diversifying your investments across different types of assets. One important note: know how long you can commit your cash before you decide to buy a junk fund. Many junk bond funds do not allow investors to cash out for one to two years.

Also, there comes a point in time when the rewards of junk bonds don't justify the risks. Any individual investor can determine this by looking at the yield spread between junk bonds and U.S. Treasuries. As we already mentioned, the yield on junk is historically between 4-6% above Treasuries. If you notice the yield spread shrinking below 4%, then it probably isn't the best time to invest in junk bonds. Another thing to look for is the default rate on junk bonds. An easy way to track this is by checking out the Moody's website.

The final warning is that junk bonds are not much different than equities in that they follow boom and bust cycles. In the early 1990s, many bond funds earned upwards of 30% annual returns, but a flood of defaults can cause these funds to produce stunning negative returns. (For more insight, read *Basics Of Federal Bond Issues*.)

Conclusion

Despite their name, junk bonds can be valuable investments for informed investors. But their potential high returns come with the potential for high risk.

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