



An Introduction To Corporate Bond ETFs

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The corporate bond market is one of the largest and most [liquid](#) of the financial markets. [Corporate bonds](#) can be appealing for many reasons, as they are generally considered safer than stocks and they often provide higher returns than government bonds. However, until recently, investing in the corporate bond market was a more difficult task for individual investors. This has changed, with the introduction of [exchange-traded funds](#) (ETFs) focused on corporate bonds. This article will focus upon the corporate bond market and whether corporate bond ETFs are an attractive option for individual investors. (For background reading, check out our tutorials on [Bond Basics](#) and [Advanced Bond Concepts](#).)

Corporate Bond Market Characteristics

Corporate bonds are issued by companies ranging from the largest and most creditworthy to smaller and more speculative firms. One of the defining features of corporate bonds is that they carry more [default risk](#) than many other types of bonds. This increased default possibility, known as credit risk, means that investors in corporate bonds are required to do significant credit research prior to purchasing securities. (Learn more in [Opportunistic Credit Investing](#).)

Corporate bonds are also analyzed by credit rating agencies, such as [Moody's](#) and [S&P](#). These rating agencies assign credit ratings to corporate issuers. This rating is one of the most important factors in analyzing corporate bonds, and can serve as a starting point for analyzing the corporate bond market. Standard & Poor's ratings range from AAA to D - securities rated above BB are considered investment grade securities, while those with lower ratings are referred to as [high yield](#) (junk) securities. Generally speaking, the higher the rating the more creditworthy the company.

While credit ratings can serve as an excellent starting point for analysis, successful investors go beyond the ratings and analyze the underlying fundamentals of the company. By doing significant additional research on corporate bond issues, investors can be very successful over the long run.

Why Invest in Corporate Bonds?

Because they are generally considered riskier than many other types of bonds, corporate bonds provide higher returns. This makes them attractive to investors willing to accept a little more risk. At the same time, corporate bonds are considered safer than common stocks, because in the corporate structure of a company, bondholders receive priority over stockholders in the event of a corporate [bankruptcy](#). Therefore, corporate bonds occupy an interesting niche - providing higher returns than government bonds with greater safety than stocks. Finally, because they are not perfectly correlated with stocks, government bonds or any other asset class, corporate bonds provide a means of bringing additional [diversification](#) to a portfolio. (For more on corporate bonds, see [Corporate Bonds: An Introduction To Credit Risk](#).)

Corporate Bond Investing Options

As mentioned previously, investing in individual corporate bonds requires significant research. Individual investors interested in directly purchasing corporate bonds should be prepared to conduct this research. Because the structure of the bond market is so heavily tilted towards large [institutional investors](#), it can sometimes be difficult for individual investors to receive reasonable pricing or to purchase bonds in small enough increments in order to build a well-diversified portfolio. Therefore, investors will ideally have a relatively large portfolio before considering purchasing individual bonds.

Because of the difficulties involved in purchasing individual corporate bonds, many individual investors seek other means of investing in the market. Some investors, particularly wealthy ones, will find that their best option is to hire a professional [money manager](#) with expertise in the bond market. This will provide them with the benefits of active bond management, personalized service and potentially above-[index](#) returns.

Investors with smaller portfolios may not be able to access professional management and may not have the expertise or ability to invest in individual bonds. For these investors, [mutual funds](#) and ETFs provide the best options for investing in the corporate bond market. (Learn more about investing in bonds in [The Bear On Bonds](#).)

Pros and Cons of ETFs

As with any financial instrument, ETFs have both pros and cons. Some of these include:

Pros:

- *Low fees* - because ETFs are passively managed and designed to track an index, they generally have very low fees. In fact, the fees on ETFs are often lower than on index mutual funds.
- *Ease of trading* - because they trade on an exchange just like any other stock, ETFs are very easy to trade.
- *Tax efficiency* - because an ETF portfolio does not experience very high [turnover](#), they are generally tax efficient.
- *Diversification* - in the corporate bond market, it can be difficult for smaller investors to build a well diversified portfolio. An ETF provides instant diversification.

Cons:

- *Limited upside* - an ETF limits an investor to the return on the index less any fees. In the corporate bond market, an active investor may be able to take advantage of market inefficiencies to produce above-index returns. However, by investing in [leveraged ETFs](#), investors can create similar above-index returns.
- *Lack of transparency* - although they regularly post their holdings, an investor may not know exactly what bonds an ETF holds at any given time. Investors with direct corporate bond holdings will have the advantage of tracking their holdings on a more consistent basis.
- *Lack of customization* - an ETF investor is forced to hold all the bonds in the underlying ETF and cannot decide to [overweight](#) or [underweight](#) some bonds relative to the index. Active investors may be able to use their skill to select corporate bonds they deem to be superior and produce higher returns over time. (For more on ETFs, read [How To Use ETFs In Your](#)

[Portfolio](#).)

Available ETFs

In recent years, a number of corporate bond ETFs have come to market. There are ETFs available for both [high grade corporate bonds](#) and [high-yield corporate bonds](#). When constructing a portfolio of corporate bond ETFs, the most important decision will be whether to purchase high-grade or high-yield corporate bonds.

The choice depends on individual circumstances and the goals of the investment portfolio, but it is important to remember that returns on high-grade bonds will generally be lower than high-yield bonds. However, high-grade bonds are also significantly safer than high-yield bonds. Therefore, if the corporate bond investment is intended to provide a measure of safety to a diversified portfolio, high-grade bonds may be more appropriate. If, on the other hand, the goal of the corporate bond investment is to generate the highest return possible, an investor may wish to investigate high-yield bonds further.

Conclusion

Like all investment vehicles, corporate bond ETFs have attractive features and drawbacks. For many individuals, including those with relatively small portfolios, a corporate bond ETF may prove the best alternative for achieving corporate bond exposure. The purchase of a corporate bond ETF can provide a well-diversified high-grade or high-yield corporate bond portfolio at a reasonable cost. However, investors with larger portfolios may find that they are able to better customize their portfolio and/or possibly achieve higher total returns by directly owning corporate bonds or hiring a professional manager.

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