

Retail-Targeted Corporate Debt: What You Need to Consider

Investment comes down to weighing risk against reward. Most of the time deciding between two competing investments involves a subjective element – since a given investor’s risk tolerance, or willingness to assume more risk in return for more expected reward, can be highly personal. For example, one might have a return “target” in mind – beyond which taking on more risk becomes increasingly unattractive. For this reason, it is frequently difficult to make absolute statements about the relative attractiveness of competing investments. Caveats are necessary as to risk tolerance, investment objectives, etc. In a small number of cases, however, the analysis is straightforward. When someone shows you two investments having similar expected returns and time horizons, but asks you to choose the one with higher risk, the answer should be “NO”.

Unfortunately, new issue corporate notes designed for and targeted toward retail investors usually fall into the latter category. These offerings include such programs as InterNotes, DirectNotes, SmartNotes and others. For no additional yield, retail investors are asked to assume the risk that there may be few, if any, bids for the notes should they desire to sell prior to maturity. Therefore, except in a small set of special circumstances, they are an inferior investment.

Case in point: General Electric Capital Corporation (“GECC”) brought a new issue under its InterNotes program on October 5, 2009 - CUSIP 36966R4P8 - the non-callable 4.10% issue maturing on 10/15/2015 and offered at par (\$100.00) for a yield to maturity of 4.1%.

There has been some controversy about the GECC credit over the past year or so due to the credit crisis. Perhaps you like GECC as a credit risk, perhaps you don’t. Perhaps you think there is another credit

which is more attractive, perhaps not. For this analysis, however, it is important to note that one’s credit view on GECC is irrelevant. Why? Because in order to evaluate the GECC InterNote offering on an apples-to-apples basis, we need to compare it to other similar (*pari passu* in credit analyst jargon) GECC debt issues and demonstrate that one can buy a different debt issue that offers higher return for the same risk, lower risk for the same return, or both. If this can be established, then the InterNote should be avoided regardless of one’s opinion on the credit.

The most similar GECC issue is the recent non-callable GECC 4.375% maturing on 9/21/2015 - CUSIP 36962G4F4. Although this \$600 million in size issue was targeted to institutional accounts, on October 5, 2009 \$525,000 was being offered on a leading retail electronic trading platform at \$101.369 for a 4.113% yield to maturity.

In terms of liquidity, TRACE (the corporate bond trade reporting system of FINRA - the Financial Industry Regulatory Authority - successor to the former NASD) shows that trading volume on October 5, 2009, for the GECC 4.375% issue was over \$31 million. In contrast, liquidity for retail-targeted issues is an unknown. As pointed out in the GE Capital InterNotes Prospectus Supplement:

The agents have advised us that from time to time they may purchase and sell notes in the secondary market, but they are not obligated to make a market in the notes and may suspend or completely stop that activity without notice and at any time.

Recent history has shown that one should expect the worst in terms of liquidity should a credit become distressed. The *Wall Street Journal* reports that on Friday, July 17, 2009 CIT InterNotes were the most

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actively traded corporate bonds that day amidst rumors of the company filing for bankruptcy. Unfortunately for the retail investors doing the selling, data collected by the BondDesk Group show the average trade price of CIT InterNotes was 10 cents on the dollar lower than for equivalent CIT institutional corporate debt (42 versus 52 cents on the dollar). Moreover, retail investors who sold that day were also hurt by the fact that the average difference between where bonds were bought and where they were sold was 6.34% for CIT InterNotes versus an average 1.06% difference for all other corporate bonds traded that day*.

As concerns about CIT's financial status grew, the difference between where CIT InterNotes and the equivalent institutional debt was trading widened. An August *Bloomberg* article on CIT's participation in the InterNotes program reported that CIT retail bonds were trading 14 cents on the dollar below the most similar institutional issue (48 cents on the dollar to yield 64% versus 62 cents on the dollar to yield 38%).** Obviously, given that new issue pricing on both bonds was close to par, or \$100.00, this is a serious issue.

Lastly, a further aspect of many retail-targeted notes is the "Survivor's Option", which is a feature that, subject to certain restrictions, allows for the issuer to be forced to redeem the notes at par following the beneficial owner's death. Clearly this feature has some value, but "dying for a bid" is supposed to be investor hyperbole. For most investors, a better option is to buy a more liquid bond for which there is a two-sided (bid as well as offer) secondary market.

So is it fair to say that InterNotes are always a bad

idea? Probably not. But caution is warranted, and an opportunistic approach is called for. The concept behind retail-targeted corporate bond offerings made some sense in the past given the historic hurdles to investing in individual bond issues for a retail investor. But markets have changed, and the dramatically increased demand for fixed income has led to improved access and liquidity at the retail level, both on the way in, and on the way out.

Investing in retail-targeted notes should not be the default choice. Instead, one first needs to consider the following factors:

- » First, with respect to liquidity, not unlike the case with bank certificates of deposit, if an investor might need to sell prior to maturity, then a retail-targeted note should be avoided.
- » Second, compare the price and yields available on retail-targeted notes with those available on institutional-targeted debt available through retail distribution channels. Unless the yields are much more attractive, stay away.
- » Further, avoid situations where a distressed issuer (such as CIT) has been shut out of the institutional market and where retail has become the lender of last resort. When institutional buyers have stopped lending money to an issuer in the new issue bond market, chances are that it is for a good reason.
- » Finally, if having done your homework you are willing to forgo liquidity – make sure you get paid for it. Since the bid will likely be much lower for a retail bond, make sure you are only willing to buy one which is offered much lower as well.

-Eric Maisel, CFA

* Andrew Jones, "Small Bondholders Soaked on CIT InterNotes," *The Wall Street Journal*, July 20, 2009.

** Caroline Salas and Pierre Paulden, "CIT Bonds Sold to Widows Have Fine Print That Pimco Resists," *Bloomberg*, August 20, 2009.

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Institutional Capital Markets
www.FTCapitalMarkets.com
800.872.7276

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