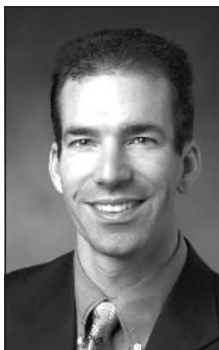


THE PLAIN DEALER

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ASK THE EXPERT

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Credentials: Certified Financial Planner, Certified Public Accountant, Certified Investment Management Analyst

Experience: 15 years

Assets under management: \$200 million

Question: *I have corporate bonds for several big-name companies, including General Motors and some financials. What happens to my investment if these companies go bankrupt? Will the U.S. Treasury or FDIC step in?*

Advice: Unfortunately, amidst the recent economic downturn, your question has touched on an increasingly popular subject matter. Although the current default rate for investment grade corporate bonds is extremely low (less than 1 percent), owning debt of a company that has filed for bankruptcy can be a very painful experience.

Furthermore, you cannot rely upon government intervention to rescue your distressed security. Chances are you would receive pennies on the dollar of your original investment if the company went belly-up.

The good news is there are ways to prevent this disaster in the future. You can limit your risk exposure by avoiding investments in individual companies.

This strategy can be easily achieved by utilizing a well-diversified bond fund, such as the Vanguard Total Bond Market Index, which is composed of several thousand different companies and government securities — so your eggs are spread throughout multiple baskets. Remember, diversification is the only “free lunch” available on Wall Street.

If you find yourself holding a company that is teetering on the edge of insolvency, it’s important to understand the corporate bankruptcy process.

“According to the Securities and Exchange Commission, during Chapter 11 bankruptcy, bondholders stop receiving interest and principal payments, and stockholders stop receiving dividends.”

In a Chapter 7 liquidation, the company stops all operations and goes completely out of business. A trustee is appointed to liquidate the company’s assets and the remaining money is used to pay off debt.

The impact on investors: In this worst-case scenario, there’s a predetermined priority that dictates the order in which investors are paid back. The pecking order is secured creditors, then regular bondholders, then equity shareholders. Attorneys take their share of the pie first.

A Chapter 11 reorganization (which is more common) is extremely complex and expensive. It involves reorganizing the company’s business affairs and assets. The company expects to return to normal business operations and sound financial health in the future, but requires time to restructure unmanageable debt.

The impact on investors: According to the Securities and Exchange Commission, during Chapter 11 bankruptcy, bondholders stop receiving interest and principal payments, and stockholders stop receiving dividends.

If you are a bondholder, you may receive new stock in exchange for your bonds or a combination of stock and bonds in the reorganized company. The new securities

may be fewer in number and worth less. The reorganization plan spells out your rights as an investor and what you can expect to receive, if anything, from the company.

Although history can serve as a guide, it’s important to remember each bankruptcy proceeding is a case-by-case hearing. Most recently, Chrysler filed Chapter 11 on April 30. The four largest creditors, who together hold 70 percent of Chrysler’s debt, expect to recover 32 cents for every dollar of debt held.

In summary, you can stack the odds in your favor if you focus on high-quality issues and diversifying your bond holdings.

Overall, investment-grade corporate bonds have a much lower chance of default and a greater recovery rate compared with their high-yield counterparts. However, default rates are expected to increase and recovery rates are expected to drop in 2009 as excesses in the credit market continue to be worked through.