F I X E D   I N C O M E

Modeling Corporate Bond Returns

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We propose a new conditional factor model for corporate bond returns with four factors and time-varying factor loadings instrumented by observable bond characteristics. We have three main empirical findings. First, our factor model excels in describing the risks and returns of corporate bonds, improving over previously proposed models in the literature by a large margin. Second, using bond characteristics to instrument evolving bond risk exposures significantly improves not only our model, but also previously proposed models of observable corporate bond factors. Third, our no-arbitrage model recommends a systematic bond investment portfolio that significantly outperforms leading corporate credit investment strategies.

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