HIGH YIELD OR “JUNK’ BONDS, HAVEN OR HORROR

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A high yield, or “junk” bond is a bond issued by a company that is considered to be a higher credit risk. The credit rating of a high yield bond is considered “speculative” grade or below “investment grade”. This means that the chance of default with high yield bonds is higher than for other bonds. Their higher credit risk means that “junk” bond yields are higher than bonds of better credit quality. Studies have demonstrated that portfolios of high yield bonds have higher returns than other bond portfolios, suggesting that the higher yields more than compensate for their additional default risk. It should be noted that “unrated” bonds are legally in the “junk” category and may or may not be speculative in terms of credit quality.

High yield or “junk” bonds get their name from their characteristics. As credit ratings were developed for bonds, the credit agencies created a grading system to reflect the relative credit quality of bond issuers. The highest quality bonds are “AAA” and the credit scale descends to “C” and finally to “D” or default category. Bonds considered to have an acceptable risk of default are “investment grade” and encompass “BBB” bonds (Standard & Poors) or “Baa” bonds (Moody’s) and higher. Bonds “BB” and lower are called “speculative grade” and have a higher risk of default.

Rulemakers soon began to use this demarcation to establish investment policies for financial institutions, and government regulation has adopted these standards. Since most investors were restricted to investment grade bonds, speculative grade bonds soon developed negative connotations and were not widely held in investment portfolios. Mainstream investors and investment dealers did not deal in these bonds. They soon became known as “junk” since few people would accept the risk of owning them.

High Yield “Junk” bonds were invented to enable smaller companies or big investors to use bonds and bond markets to finance takeovers. The original concept was good and legal; but overly aggressive stockbrokers and arbitrageurs, aided by large investment firms, exploited and corrupted it. They used illegal inside information, deliberately-planted misinformation and market rigging to make millions and millions of dollars while, in some instances, destroying profitable old companies. Some of these multimillionaires are now in the penitentiary. Unfortunately, this kind of greed is still rampant.

Before the 1980’s, most junk bonds resulted from decline in credit quality of former investment grade issuers. This was a result of a major change in business conditions, or the assumption of too much financial risk by the issuer. These issues were known as "fallen angels". The junk bond market grew exponentially. During the 1990-91 recession, many of these bonds defaulted, helping bankrupt the S&L's throughout the U.S. and helping to saddle U.S. taxpayers with a trillion dollar national deficit.

The advent of modern portfolio theory meant that financial researchers soon began to observe that the "risk-adjusted" returns of portfolios of junk bonds were quite high. This meant that the credit risk of there bonds was more than compensated for by their higher yields, suggesting that the actual credit losses were exceeded by the higher interest payments.

Underwriters being creative and profit-oriented, soon began to issue new bonds for issuers that were less than investment grade. This led to the Drexel-Burnham saga, where Michael Millken led a major investment charge into junk bonds in the late 1980's, which ended with a scandal and the collapse of many lower rated issuers. Despite this, the variety and number of high yield issues recovered in the 1990's and is currently thriving. Many mutual funds have been established that invest exclusively in high yield bonds, which have continued to have high risk-adjusted returns.

In the 9 months ended 7-31-03 , junk bonds returned an average of 26.2% or an annualized return of 36.4%. The lowest bonds (Caa) had returned a record 83.2%. Through 10-31-03 , Investment Advisor Magazine reported that the Lehman High Yield index had returned 24.23% year to date. As of 12-10-03 , the widely watched Merrill Lynch U.S. High Yield Master II index has returned a stellar 26.965%, year-to date, its second best showing ever.

History, however, provides a bit of caution. A research study completed in mid-1989 by Harvard professor Dr. Paul Asquith found that an incredible 34% of all high yield bonds defaulted. He started with bonds issued in 1977 and assumed that if a hypothetical investor bought every high yield bond issue between 1978 and 1986, 34% of the bonds would have defaulted by November 1988. Professor Asquith also found that the quality of bond issues has decreased over time with higher quality issues in the early 1980's versus the late 1980's.

AN EXPLANATION OF "JUNK" BOND CREDIT RATINGS

High yield bond investment relies on credit analysis. Credit analysis is very similar to equity analysis in that it concentrates on issuer fundamentals, and a "bottom-up" process.

It is concentrated on the "downside" risk of default and the individual characteristics of issuers. Portfolios of high yield bonds are diversified by industry group and issue type. Due to high minimum size of bond trades and the specialist credit knowledge required, most individual investors are best advised to invest through high yield mutual funds.

Bonds are generally classified into two groups – "investment grade" bonds and "junk" bonds. Investment grade bonds include those assigned to the top four quality categories by either standard & Poors (AAA. AA, A, BBB) or Moody's (Aaa, Aa, A, Baa). The term "junk" is reserved for all bonds with Standard & Poors ratings below BBB and/or Moody's ratings below Baa. Investment grade bonds are generally legal for purchase by banks; junk bonds are not.

The specific definitions assigned to junk bond ratings by the services help define the magnitude of the risk associated with them. Because Standard & Poors definitions are somewhat more comprehensive, they are quoted here:

BB,B,CCC,CC,C: Debt rated BB, B, CCC, CC, and C is regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. BB indicates the lowest degree of speculation and C the highest degree of speculation. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.

BB: Debt rated BB has less near-term vulnerability to default than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to inadequate capacity to meet timely interest and principal payments.

B: Debt rated B has greater vulnerability to default but currently has the capacity to meet interest payments and principal repayments. Adverse business, financial or economic conditions will likely impair capacity or willingness to pay interest and repay principal.

Because a B rating is the single most common rating found in a junk bond portfolio, Moody's definition of its B rating follows:

Bonds which are rated B generally lack characteristics of the desirable investment assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.

To resume with Standard & Poors:

CCC: Debt rated CCC has a currently identifiable vulnerability to default, and is dependent upon favorable business, financial, and economic conditions to meet timely payment of interest and repayment of principal. In the event of adverse business, financial, or economic conditions, it is not likely to have the capacity to pay interest and repay principal.

D: Debt rated D is in payment default.

CREDIT RATINGS AND ANALYSIS

A credit rating is an assessment by a third party of the creditworthiness of an issuer of financial securities. It tells investors the likelihood of default, or non-payment. By the issuer of its financial obligations. Credit analysis is the financial analysis used to determine the creditworthiness of the issuer. It examines the capability of a borrower, or issuer of financial obligations, to repay the amounts owing on schedule or at all.

Establishing the creditworthiness of borrowers is one of the oldest established financial activities known. Throughout history, the act of lending funds has been accompanied by an examination of the ability of the borrower to repay the funds. The most ancient civilizations and societies known to us often show development of sophisticated trading and banking activities. The medieval bankers of Europe were thorough in their examination of their clients' affairs and often decided the outcome of wars and the fate of monarchies with their financing. This type of direct lending and banking relied largely on character and direct knowledge of the financial situation of the borrower.

As modern accounting and finance developed during the industrial revolution, banking and lending grew to a larger scale and became more systematic. Just as governments developed sophisticated bureaucracies to deal with the complexities of national governments, large banking and financing houses grew to cope with the demands of international trade.

Modern credit analysis developed in the late 1800's when the credit markets began to issue and trade bonds, largely to finance the development of the new world, particularly the United States. As lenders were purchasing bonds of countries and companies that they had little personal knowledge of, third party credit rating agencies such as Moody's Investors Services and Standard & Poors Corporation and Fitch IBCA were founded to fulfill the need for an impartial assessment of the creditworthiness of bond issuers.

These companies, most still active today, developed scoring systems that told investors of the creditworthiness of issuers. Each rating agency has its own nomenclature or "investment grade" that ranks the default risk of issuers. The scale begins at the highest quality ratings, AAA, with very low probability of default, and descends to risky or "speculative" ratings, BB, where the risk of default is high. Default rates for the high-yield market over the past two years peaked at nearly 12%. With defaults today in the mid-5% range and projected to go lower, the risks with this sometimes volatile and lower credit-rated asset class are not as great as many assume. The recent default deceleration can be attributed to a washout of, primarily, the telecommunications sector and other financially weak entities that could not survive the economy. Clearly, declining default rates are another reason for lower credit spreads and are obviously a positive for this asset class.

YIELD OF "JUNK" BONDS OVER TREASURIES

One of the things to look at is the difference between the 10-year Treasury bond, and the yield on the high yield index, usually a 3-4% difference. As of mid 2003, it was as high as 7%, then down to the range of 6%. Late in the year, issuers have been bringing out a host of lower-quality bonds in response to the record inflows into junk funds, according to Standard & Poors Global Fixed Income Research. Junk bonds now yield about 5% above the 10-year Treasury note, or around 9.3%, currently. Maximizing current income should be the goal for high-yield corporate portfolios. High yield historically generates 98% of its return from coupon. As a result, current income is its number one objective while capital appreciation is a secondary, though important aspect to long term performance (plus or minus 2% from capital appreciation due to general credit quality improvement and mergers and acquisitions activity)..

"JUNK" VS. "TRASH"

Trash bonds can be described as bonds that have been downgraded by Standard & Poors or Moody's, due to their financial status, to below investment grade. However, there are many junk bonds that are not trash! Some non-rated bonds such as Sears and Roebuck, Seven-Up Bottling Co. and Dr. Pepper, defray paying up to a $500,000 premium to the rating agencies to secure an investment grade credit rating. Instead, these quality companies would rather pay an additional 1/8% to 1/4% premium to the investor to invest in their unrated bonds. While these are still legally "junk" by definition, they should not be considered "trash".

TERMS

Junk bonds, like all bonds are subject to interest rate risk. For that reason, shorter maturities are advisable to reduce that risk. A range or 2-8 years is advisable with the thought of holding the bonds to maturity (less than 10 years) if interest rates rise and market values decline during the holding period. The longer the maturity, the greater the loss in market value, if interest rates rise. With an 8% coupon and a 20 year maturity, the loss of principal would be (9.2%) if interest rates rise one percentage point and (17.2%) if interest rates rise 2 percentage points! This compares to a loss of principal of only (4%) and (7.7%) for a five year maturity, respectively. With a 10% coupon, and 20 year maturity, the loss in market value would be (8%) and (15%), respectively, versus (3.8%) and (7.4%) for a five year maturity. The risk of principal loss with longer term bond maturities is like a string tied to an air conditioning duct. At the end of the string, large fluctuations occur (long maturities). The beginning part of the string where it is tied to the duct, fluctuates very little. The longer the string, the greater the fluctuations (price swings). Taxable high-yield corporate bonds historically have performed well in an improving economy despite the accompanying rising rate environment. As an asset class, high-yield corporate securities tend to benefit from rising rates. This is because rising rates generally signal an accelerating economy and/or inflation, both of which are important for the success of small to mid-cap sized companies. Growth and/or price inflation generally means a company has the ability to push through price increases. This ability in turn helps in their profitability and ability to de-leverage their balance sheet. Finally, high yield's average duration is generally lower than most traditional interest-sensitive securities. the average duration (as defined by the Lehman High Yield Index) of a high-yield bond is 4.7 years. this lower duration is obviously beneficial in a rising rate environment.

OASIS OR MIRAGE

Hungry for yield, investors are bidding up risky issues. With interest rates on savings accounts, money market accounts, and Treasury bonds at close to their recent lows after

13 consecutive rate cuts by the Federal reserve, investors thirsty for yield are plowing into high-interest – high-risk – junk bonds. Bolstered by huge inflows, an improving economy and strong investment returns, high-yield bond issuance is approaching the 12-month volume record of 1998. Through mid-December, 2003, about $129 billion in junk bonds has been sold, compared to $138 billion in 1998 according to Thomson Financial. The high-yield debt market sprang to life in the fall of 2002 after languishing in the wake of the dot-com stock collapse. This year, a low-interest-rate environment encouraged investors to seek the better yields in the junk-bond arena, while the economy encouraged them to accept the greater risk in lower-rated corporate debt.

Merrill Lynch Chief North American Economist David Rosenberg has stated that there is little economic rationale to support the current strength of the junk-bond market. Rather, it's being driven by increased liquidity with the accommodative actions of the Federal Reserve and investor's hunger for yield. Merrill Lynch analyst M. Cristopher Garman says that default rates are down.

Even though they're down now for junk bonds, says Garman: "This is actually the slowest rate of deceleration [for defaults] on record, even going back to the Great Depression." Some experts argue that the Fed's easy-money stance has made it possible for companies to clean up their balance sheets and lower heavy debt burdens, making the possibility of default less great.

Warren Buffet has recently been a big player in junk bonds and who could forget Fred Carr, who as President of Executive Life Insurance Company, built his financial empire on junk bonds. He always was heard to say, "yes, their aggressive, but in time they will be worth a fortune". He was right. In the early 1990's, Credit Lyonnais acquired Executive Life and its junk-bond portfolio for a song. U.S. prosecutors allege that Credit Lyonnais, which was then owned by the French government, skirted U.S. laws to gain control of the assets, which it later sold to Francois Pinault, the tycoon who controls fashion house Gucci and auction house Christie's. He is estimated to have made more than $1 billion from the bonds and the insurer, accounting for a big chunk of his fortune. The Executive Life insurance-fraud case is near settlement according to the Wall Street Journal, December 11, 2003 , in the amount of $760 million. On the down side, "junk" bonds have been exposed in the municipal bond arena! The share price of Heartland High Yield Municipal Bond Fund declined 70% on Oct. 13, 2000 , and that of Heartland Short Duration High-Yield Municipal fund declined 44%, as the funds wrote down some holdings of high-yield "junk" municipal bonds.

SUITABILITY

It goes without saying that "junk" bonds are speculative investments. They are then unsuitable for conservative investors seeking steady and verifiable income. For the moderate growth and income investor seeking a diversified portfolio, up to 10% - 15% of a balanced portfolio could be allocated within this high yield asset class. Compared with the “golden years” bonds should offer better diversification from stocks, as I expect the correlation between the two asset classes to remain negative. Against all expectations, stocks and bonds were positively correlated (returns rose and fell together) for much of the 1980’s and 1990’s, as productivity gains and declining inflation benefited both markets. Now, however, both assets should track the economic cycle more closely and stock and bond prices should move in opposite directions. This allocation is strengthened if “junk” (quality unrated bonds) as opposed to “trash” is emphasized. Heavy concentration in this speculative asset class is unsuitable for most investors without the highest aggressive risk tolerance. Diversification through the purchase of bond mutual funds as opposed to individual issues can help in providing a higher yield haven for investors rather than a horror.

BOND SCORECARD

- Highest Quality………..AAA
- Very Good Quality……AA
- Good Quality………….A
- Medium Quality……….BBB (Investment Grade)
- Lower Medium Quality..BB
- Poor Quality…………..B

- Speculative Quality….. .C
- Default………………..D

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