

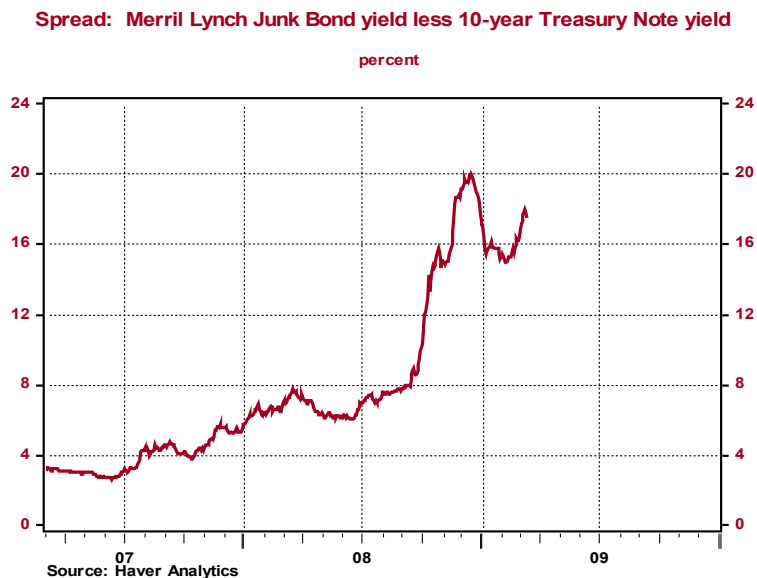
Junk is Still a Four Letter Word

By Robert Huebscher

March 17, 2009

Investors salivate at the thought of a diversified asset class offering 20% returns. That is the stuff of which legends are made.

It also describes junk bonds, more euphemistically known as the high yield sector. Historically, high yield bonds have traded at less than 400 basis points above comparable Treasury bonds. Today, those spreads have spiked to between 1,600 and 2,000 basis points, as the chart below illustrates (courtesy of Northern Trust):



Considering that these spreads are above and beyond the 3% yields 10-year Treasury bonds already earn, it's not hard to see why this sector is drawing a lot of attention

High-yield spreads typically spike in recessions. But today's spreads are far larger than in either of the previous two recessions (1990 and 2001), when spreads peaked around 1,000 basis points.

That means the average high yield bond now trades at 60% on the dollar, well below its previous low of 68%.



Depressed asset prices - fueled by irrational fears - are pushing the flow of funds into the high yield sector.

“Since mid-December investors have been gradually returning to the high yield market,” said Zane Brown, a Lord Abbett fixed income strategist. “Mutual fund flows have been consistently positive and spreads have narrowed from 2,100 basis points above Treasuries to 1,800 basis points now, still a compelling valuation level. Current spreads of 1,800 basis points far exceed previous record wide spreads of 1,100 to 1,200 basis points in the recessions of 1991 and 2002. Current spread levels imply default rates of 18 to 24%, compared to the actual rate of about 12% in the recessions of 1991 and 2002.”

Default is the ultimate risk faced by high yield investors. Were it not for the possibility of defaults, there would be no question whether these bonds are undervalued.

But, of course, defaults cannot be ignored. As of the end of February, the high-yield default rate was 6.42%, following rates of 4.96%, 4.02%, and 3.15% in January, December, and November, respectively. Standard & Poor’s estimates the default rate could top 13.9% by the end of 2009.

That’s still a lot less than the default rate priced into the market today, but default risk is not the only barrier between advisors and the elusive 20% return.

Actively managed funds

High yield investors can choose from actively managed funds and ETFs. But each choice poses problems for the advisor.

Below is a sample of some of the actively managed high yield funds.

Symbol	Fund	Expense Ratio	Yield to Maturity
AHYVX	AMERICAN CENTURY HIGH YIELD	1.05	9.53%
CPHYX	PRINCIPAL HIGH YIELD FUND	.53	13.69%(1)
GSHAX	GOLDMAN SACHS HIGH YIELD FUND	1.07	9.80%
HYFAX	HARBOR HIGH YIELD BOND FUND	.77	11.13%(2)
LHYAX	LORD ABBETT FUND	1.23	15.30%(1)
MHCAX	MAINSTAY HIGH YIELD CORPORATE BOND	1.07	9.76%
NEFHX	LOOMIS SAYLES HIGH INCOME	1.15	12.03%
NTHFX	NORTHEAST INVESTORS TRUST	.68	20.19%(1)
OHYAX	JP MORGAN HIGH YIELD BOND FUND	1.12	16.10%



PHDAX	PIMCO HIGH YIELD FUND	.90	(3)
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- (1) As of 2/28/09
- (2) As of 12/31/08; All others are as of 3/11/09
- (3) PIMCO does not quote the yield to maturity on this fund

The yields of actively managed funds trail the elusive 20% mark by at least 400 basis points (except for the beleaguered Northeast fund – see [here](#)). Expense ratios that can exceed 1 percent contribute to this discrepancy, but the actively managed nature of these funds is a bigger culprit. Managers seek higher risk-adjusted returns by selecting better-quality issuers and shorter maturities, or by holding cash, convertible bonds or preferred stocks – all of which reduce the yield of their funds.

On top of this, actively managed funds often have high turnover – 50% or more.

A word of caution is in order here. When choosing among these funds, advisors need to obtain the average yield to maturity for a portfolio and not rely on two more common – but misleading – metrics. Yield to maturity is markedly different from both the 30-day SEC yield (a nearly useless metric that resembles the “current” yield) and the trailing 12 month yield published by Morningstar (which measures prior performance and not the current holdings in the portfolio).

Mike Weldon, Lord Abbett’s director of retail marketing, shared our concerns about fund evaluation. “Financial advisors considering high yield funds, especially in this credit environment, should focus on two criteria,” he said. “Depth and experience of the management team, because credit analysis will be extremely important in selecting the credits with attractive potential and if defaults increase, and proper spread of risk in the fund. Not all high yield funds are created equal so it is important to determine the fund’s construction among issues and sectors.”

Exchange Traded Funds (ETFs)

ETFs avoid many of the problems with actively managed funds, because they have lower expense ratios, lower cash levels, lower turnover, and they track a highly structured index.

But ETFs have other problems, which are illuminated in the three ETFs tracking the high yield sector:



Fund	Index Tracked	Expense Ratio	Yield To Maturity	Number Of Holdings
HYG	iBoxx \$ Liquid High-Yield	.50	17.28	50
JNK	Barclays High Yield Very Liquid	.40	18.87	120
PHB	Wachovia High-Yield Bond	.50	N/A	53

With over \$2 billion in assets, HYG is the default proxy for the sector, and it holds approximately 50 highly liquid bonds. But holding only 50 bonds causes a lack of diversification.

JNK is fairly similar to HYG with about twice as many holdings. It has just over \$900 million in assets. PHB is fairly new and uses a quantitative overlay to choose the issues with the best credit quality. It has \$62 million in assets.

A highly liquid high yield bond is an oxymoron. On a good day, these bonds might trade once, and most of the time they don't trade at all. For ETFs, which must be priced every 15 minutes, that creates lots of problems.

One is that ETFs typically trade at significant discounts or premiums to the NAV of the index they track. HYG, for example, currently trades at a 3% premium.

A related problem is tracking errors relative to the index. This was demonstrated in 2008 by the AGG ETF, which tracks the broader bond market. The AGG returned 7.91% versus 5.24% for the underlying index. The 172 bonds that make up the ETF were supposed to track the index, which contains more than 9,000 bonds, but high volatility and illiquidity in 2008 kept that from happening.

Liquidity problems don't exist in the equity markets, where ETFs work very well. But in the bond market liquidity matters a lot more for ETFs than it does for mutual funds and, according to Matt Hougan of Index Universe, these problems are at the most extreme in the high yield market. "Finding the sweet spot between liquidity and diversification is the huge issue in bond market ETFs," Hougan said.

There are no true high yield index funds. Vanguard's offering, its High Yield Fund (VWEHX), is an actively managed fund with a low expense ratio (.25 on investor shares). It invests in better-quality high yield bonds, and its yield to maturity is currently 12.7%.



Macro factors weigh heavily

Although you can argue that the high yield sector has already priced in the risk of a Depression, much can still happen to cause spreads to widen further.

A lot of high-yield debt is held by hedge funds and private equity firms. As they face ongoing client redemptions and forced de-leveraging, these funds will continue to be net sellers, depressing prices even further.

In the event of default, recovery rates are likely to be low. Asset recovery is typically based on real estate values, and the likely value of bankrupt companies' commercial real estate may be insufficient to achieve historical recovery rates of 60-70% on defaulted debt. Recovery rates have already dropped to 20%-40%.

Approximately \$680 billion of corporate debt will mature by the end of 2009. With credit markets frozen, issuers are unlikely to refinance that debt.

David Thompson, who manages fixed income portfolios for Highmount Capital, a \$1.3 billion New York-based multi-family office, says it is still too early to enter the high yield market. "I am worried about recovery risk, cash flow risk, refinancing risk, and the overall business environment these issuers face," Thomas said.

Thompson sees the flow of funds into high yield debt as a red flag. "If the rest of the world wants these assets, then it is the wrong place to invest," he said.

Ultimately, if your forecast includes another 18 or more months of recession, then the best opportunities for buying high yield bonds lie ahead.

Macroeconomic concerns aside, don't expect diversification benefits from this asset class. We recently wrote about the research conducted by Sebastien Page, of State Street Advisors, and his colleagues [see [Why Diversification is Failing](#)]. They measured the upside versus downside diversification value of asset classes against US equities. Ideally, asset classes should have low correlation with equities in down markets (when diversification is valuable) and high correlation with equities in up markets (when investors could use a little less diversification).

By that criterion, high yield debt has an undesirable correlation asymmetry score of 43.8%. But medium grade debt has a desirable score of -20.0%. Page believes high yield bonds suffer in this regard from their important equity component on the downside. "If the company does well, you hold debt. If the company is not doing well, your returns behave more like equity," he said.



Our thoughts

Among investment grade issuers, 10-year GE bonds currently yield approximately 10%. High yield funds offer an additional 500 basis points. The question every advisor must ask is whether this 500 basis point spread is justified by the risk of junk bonds, as compared to owning a nearly risk-free security.

High yield bonds should play a relatively small role in an investor's asset allocation. Given this, I'd rather hold the undiversified GE bond than a fund of high yield bonds, some of which I know will default. (If holding an undiversified GE position is unacceptable, then you can own the LQD investment grade bond ETF, which currently yields 7.22 %.)

Lastly, a basic investment principle is that you should always understand the true nature and magnitude of the risks you are taking. That is not possible with junk bonds – you cannot evaluate the credit of every issuer in a fund. Don't assume that diversification eliminates these risks. Not too long ago, investors bought collateralized mortgage obligations without knowing the true nature of the risks of the underlying assets. They believed diversification eliminated those risks. We all know how that story ended.

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