



Tantalizing Opportunities in High-Grade Bonds

By Robert Huebscher

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High-grade corporate bonds are selling at compelling yields on a historical and absolute basis. Advisors funding income portfolios should look closely at this asset class. But the potential for rising inflation and credit defaults has been heightened by the unprecedented financial crisis and huge corporate failures that have already occurred.

When the bond market closed on Friday October 24, a Goldman Sachs 6.15% 2018 bond was trading at \$83 to yield 8.85%. That represented a yield spread — the interest above an equivalent-term Treasury — of 524 basis points. Typically, that spread would be well under 100.

Going further out on the maturity spectrum, investors were rewarded with similar spreads. The Comcast 6.40% 2038 bond was yielding 8.43%. The AT&T 6.40% 2038 bond was yielding 8.53%, and the Home Depot 5.875% 2036 bond was yielding 10.00%. Thirty-year Treasury bonds are trading at slightly over 4.00%, so these are spreads of 400-600 basis points for high-grade liquid issues.

Clearly, the high-grade bond market is pricing in a worst case scenario.

According to Elaine Stokes, co-portfolio manager of the Loomis Sayles Bond Fund, “investment grade credit is trading at historical levels - a long term investor will surely be rewarded for taking the plunge.”

For advisors constructing income portfolios, quality high-paying bonds represent an intriguing opportunity to lock into near double-digit yields. However, high-grade bonds may still prove to be a volatile asset class, subject to risks from deteriorating economic conditions, widening spreads, along with rising inflation, interest rates, and defaults.

Reading Spreads

According to J.P. Morgan’s High-Grade Strategy and Credit Derivative Research, the average spread on its industry-diversified, high-grade portfolio has soared to 426 bps. During the summer of 2007, it was less than 50 bps.

Two forces have caused spreads to explode. Corporate yields are rising due to the combination of frozen credit markets, recession anxiety, and rising default



rates. According to Standard & Poor's, investment-grade defaults were virtually non-existent over the past several years. But, as of August, defaults had jumped to 32 basis points, and are expected to rise further.

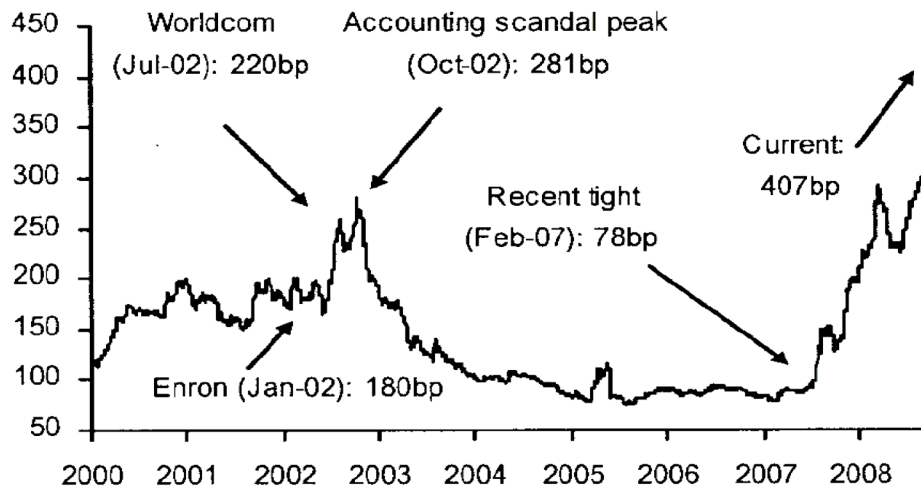
	Global	U.S. ¹	Europe ²	EM ³
12-month rolling⁴				
Investment-grade	0.15	0.32	0.00	0.00
Speculative-grade	1.88	2.50	1.00	0.00
All rated	0.89	1.44	0.18	0.00
2007				
Investment-grade	0.00	0.00	0.00	0.00
Speculative-grade	0.86	0.97	0.98	0.18
All rated	0.36	0.48	0.18	0.11
2006				
Investment-grade	0.00	0.00	0.00	0.00
Speculative-grade	1.14	1.33	1.81	0.39
All rated	0.46	0.63	0.37	0.23
2005				
Investment-grade	0.03	0.06	0.00	0.00
Speculative-grade	1.41	1.97	0.47	0.22
All rated	0.57	0.93	0.09	0.13

Source: Standard & Poor's, September, 2008

But that's only half the story.

At the same time, the flight to quality has compressed Treasury yields to some pretty deep lows. Investors are pouring into supposedly ultra-secure government paper, further widening the spreads. Three-month notes were recently paying 5 basis points; one-month notes were being purchased above par, offering negative yields.

Chart 1: HG bonds spreads are at decade-wide levels



Source: JP Morgan, September 24, 2008

Fund Managers' Views

Loomis Sayles has seen the yield of its flagship Bond Fund (LSBDX) climb to 8.53%. But year-to-date returns through October 10 had cratered by more than 25%. Portfolio co-manager Daniel Fuss acknowledges that the firm, after successfully sidestepping the subprime mess, moved too early into the falling corporate debt market in late 2007.

But Fuss believes that “once the systemic pressures ease and liquidity returns, debt holdings will rise significantly as underlying fundamental value is recognized.”

He points to a recent report his firm published that tracked the performance of Treasuries, high-grade, and high-yield bonds during the last three crises: the Savings & Loan debacle of the early 1980s, Long-Term Capital’s implosion coupled with the tech collapse, and the current sub-prime meltdown.

During the first two events, investment-grade and high-yield bonds underperformed Treasuries. But in the periods that *followed* the crises, as spreads reverted to their pre-crisis level, corporate bonds significantly outperformed Treasuries.



Recovery Periods	Dates	Duration (months)	Treasury Return	High Grade Return	High Yield Return
S&L Crisis	12/90 - 4/92	16	13.91%	18.23%	57.58%
LTCM/Tech Collapse	10/02 - 2/05	28	7.44%	19.63%	56.39%
Subprime Crisis <i>(to date)</i>	?	?	?	?	?

Source: Barclays US Treasury Index, US High Yield Index, and US Corporate Index

But this begs the question: is the current meltdown comparable to those previous crises, where the underlying financial system wasn't being challenged, or are we dealing with a systemic failure? Not knowing is the rub.

A key reason why so many big-name investors have been taken to the woodshed by the current sell-off is that, even after a year since the symptoms of the financial crisis were made public, we still don't know how sick and how contagious the banking system is. We still don't know what percent of their assets are infected. We still don't know the scale of credit default swaps that have been underwritten and who is on the hook for them.

Government officials are only now admitting that they should've taken action much earlier than they did. Such a statement is deeply troublesome, making us wonder, what did they know and when did they know it? With such ambiguity, there is little way to have confidence in anyone's call that the worst is over—even when it is.

Hunter Meisenheimer, associate vice president of fixed income research at Morgan Keegan, agrees. He's underweighting the high-grade market: "We frankly do not see a catalyst that will stop the current cycle. When (or perhaps "if") things do stabilize, the correction should be swift and steep. But we do not see it happening yet."

But many other analysts think the market may be close to bottoming, and they are recommending a return to high-grade debt.

Zane Brown, a fixed-income analyst at Lord Abbett, sees clear dysfunction in the bond market as evidence that fear has trumped fundamentals. He points to the irrationally small and even negative yields on short-term Treasuries. During major periods of turmoil, he would anticipate high-grade corporate spreads to move from around 80 bps to 130 bps, not 400, 500, or 600 bps.

Although he believes government commitments will successfully address the crisis, he sees capital markets still questioning the ultimate efficacy of intervention. "My only real concern is if both institutional and retail investors ignore new government initiatives and convince themselves that a Great Depression-like market is



inevitable,” says Brown.

He sees the economy coming out of recession by second quarter 2009 and bonds gradually improving over the following year. That is why he sees a rare opportunity in today’s yields. Brown is recommending high-grade 10-year maturities because of their extensive offerings and liquidity. (Because the yield curve is relatively flat beyond 10 years, investors wouldn’t get significantly compensated for the additional risk and volatility of longer maturities.) The combination of high yields and capital appreciation (if yields contract) could generate double-digit annualized total returns, posits Brown.

Looking towards Europe, Neil McLeish, European credit strategist at Morgan Stanley, is also optimistic: “We are upgrading to an outright bullish stance on European credit markets for the first time since the start of the current bear market.” He’s more enthusiastic about bonds than he has been since the bottom of the last bear market in October 2002.

In terms of pricing, McLeish says “valuation is now extreme even on a 100-year view, sentiment reflects outright panic and an underlying sense of exhaustion and disbelief, and fundamentals for higher-quality credit are now improving (but ignored), in our view.” Specifically, he’s overweight investment-grade debt, especially in the largest European banks and non-cyclical corporates.

Tim Bond, head of global asset allocation at Barclays Capital, has shifted his previous zero fixed-income exposure to a 25% weighting in bank debt, and he has even established a 10% weighting in subprime, indicating that some bold money is betting that the most toxic layer of the fixed income markets may be underpriced.

Caveat Emptor

There is little doubt that fear is playing a big role in the collapse of securities markets. What’s more, the scale of government intervention is huge and unprecedented. Still, we are venturing into unknown territory, which means there can be no assurance of how things will play out.

The severity of the crisis has taken our eyes away from what is traditionally the essential concern for bond valuations and returns: inflation. The government’s bailout and rescue actions will likely fuel rising prices, even though the precipitous collapse of commodity prices and a strengthening dollar have helped relieve near-term inflationary pressure.

One would be hard pressed to find an economist who isn’t deeply concerned about the sudden infusion of billions of dollars into the banks, coordinated multi-market interest rate cuts, inevitable fiscal stimulus packages, and what all of the above will



mean for consumer prices and interest rates.

Even when the financial infrastructure isn't under siege, it's virtually impossible for governments not to overshoot in promoting growth and avoid generating inflation. If inflation approaches double-digit levels, today's enticing bond prices may not prove to have been cheap enough.

So what then should be done?

Navigating the Market

Most advisors will prefer to utilize funds instead of individual bonds. However, as the tables at the end of this article illustrate, high-grade bond funds yield noticeably less than individual bonds.

But funds offer many advantages over individual bonds. According to Loomis Sayles' Stokes, "for the average investor it is more appropriate to buy a fund because it provides immediate diversified exposure, liquidity, the benefits of getting in at real market levels (instead of paying up to do odd lot trading), and a team of resources to watch the credits as we weave our way through a difficult economy."

Advisors should note several points about the high-grade bond funds and ETFs listed below. First, none provide exclusive exposure to the high-grade corporate market. The exposure among bond funds ranges from 11.4% to 75.1%. To the extent that these funds own Treasury and mortgage-backed debt, yields will be lower. Second, historical performance – specifically, year-to-date performance – is not a useful guideline in selecting funds. These funds all held high-grade bonds earlier this year, and would have experienced poor performance as spreads widened. Recent past should not be the yardstick for gauging future performance. These funds may shift maturity and credit exposure as opportunities change. Lastly, consider our list of ETFs as a starting point for future research. Advisors will need to explore the indices on which these ETFs are based and the degree to which they capture exposure to the high-grade market.

We asked Stokes about the 53.6% exposure to investment grade debt in Loomis Sayles' Investment Grade Bond (LIGRX) fund. She said that, on the margin, she expects that exposure to increase. She added that, "as this credit crunch develops, a broader and more diversified number of fixed income issuers are starting to trade at very attractive prices. Investment grade corporate bonds were the second leg to fall after the securitized market; now high yield, emerging markets, non-US dollar, and convertible markets are repricing themselves."

For retirement portfolios with long term time horizons, a decision to go into high-grade bonds should be based on a belief that the crisis is correctable over the next



year or two.

The safest, least volatile plays are short-term. But if you believe conditions will start to improve over the coming year, you may wish to go into longer maturities to lock in these ostensibly rich yields. But leave some powder dry. Markets typically bounce around their lows before recovering in earnest, so we could see even greater bargains over the coming months. The standard rules of diversification still apply. Choose a range of industries that offer essential products and services that will continue to generate sufficient free cash flow during a recession. Ladder the portfolio with varying maturities to balance performance.

But the real opportunity today is in income portfolios for clients who, for example, may be at or beyond retirement age. Funding these portfolios, at least in part, with high-grade bonds at today's yields deserves serious consideration. In this case, the expectation is that the bonds will be held to maturity. The primary risk is inflation or hyperinflation (which would decrease the purchasing power of future coupon payments), and this risk can be mitigated by including TIPS in the same portfolio. Especially if individual bonds are used, the risk of default must be assessed. Bond defaults imply bankruptcy, and it is unlikely that issuers like Goldman Sachs will not be around in 10 years. But we've seen some pretty crazy things happen this year.

Stick with senior, high quality bonds. There's already enough yield and risk in the bond market, and there's no need to shoot for extra income by venturing lower down the capital and rating structure.

Our final thought regards the credit ratings agencies. You cannot rely on their guidance. At best, consider their grades a starting point for your own research, mindful that an issuer's name is no longer assurance of future performance.

Sample of Investment Grade Bond Funds

Ticker	Fund	Expense Ratio	Yield	% in Corporate Bonds	YTD Perf	5-Year Perf
FIIGX	First Investors Investment Grade	1.10	5.69%	75.1%	-14.98%	-0.31%
FBNDX	Fidelity Investment Grade Bond	.45	4.95%	24.2%	-7.55%	1.52%
LCRYX	Lord Abbett Core Fixed Income I	.55	5.05%	14.1%	-2.59%	3.17%
LIGRX	Loomis Sayles	.83	6.04%	53.6%	-18.30%	2.27%



	Investment Grade Bond					
RFASX	Russell Investment Grade Bond	.40	5.35%	11.4%	-5.86%	2.30%
STGIX	RidgeWorth Investment Grade Bond	.86	4.23%	37.3%	-0.90%	3.34%

Source: Morningstar as of October 27, 2008

Sample of Investment Grade ETFs

Ticker	ETF	Expense Ratio	Yield	Avg Rating	YTD Perf	5-Year Perf
LQD	iShares iBoxx \$ Investment Grade Corporate Bond	.15	6.21%	A+	N/A	N/A
CIU	iShares Lehman Intermediate Credit Bond Fund	.20	5.11%	A	-8.94%	N/A
CFT	iShares Lehman Credit Bond	.20	5.70%	A	-10.56%	N/A
UBD	Claymore U.S. Capital Markets	.57	N/A	N/A	N/A	N/A

Source: [ETF Trends](#), Morningstar, as of Oct 27, 2008

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