

Time to buy high yield?

Viewpoint: Asset allocation

Martin Fridson assesses buying opportunities in fixed income

High yield spreads narrowed by a record 450bps in the 22 days to 6 January 2009. This drop in yield spread between the ML High Yield Master II index and 10-year US Treasuries exceeded the biggest full-year contraction on record – 444 basis points in 2003.

If we were to judge solely by past record we would conclude that high yield has passed its cyclical trough as an asset class. There is no precedent for such a sharp decline in the risk premium as in recent weeks without the onset of a definitive upturn. Looking at high yield spreads over a one-year period (chart 1), the impression is that the market has reached a turning point.

The possibility of an upturn is intriguing given that high yield bond returns from the low points of the last two cycles were impressive even on the scale of the equity market. In the 12 months following the maximum spread of 1,052bps of January 1991, the ML Master II index returned 39.62%. For the 12 months following the 1,063-basis-point maximum of October 2002, the index was up 34.61%. If those were stock returns, they would rank in, or close to, the top decile of annual performance for the twentieth century.

Small wonder then that some hedge funds have diverged from their traditional equity focus to invest a portion of their assets in high yield bonds. They reckon that the credit markets must revive before stocks will experience a sustained rally.

Notwithstanding, institutional investors remain cautious about stepping up their high yield exposure. Their concerns appear to have more to do with timing than with fundamental value. They do not doubt that investing into high yield debt will probably prove profitable over the next year or two – they just worry that speculative

grade debt may suffer a relapse in the interim, imposing a performance penalty on the way to the longer-run performance payoff.

This apprehension is not altogether without foundation. As the second chart shows, the spread against Treasuries reached an all-time high this cycle, indicating an unprecedented level of risk. Moreover, 2008's volatility far exceeded anything seen in earlier periods. In the last two cycles the monthly standard deviation of high yield returns peaked at 2.89% (1990) and 3.53% (2002). The comparable figure for 2008 was 6.23%.

Issues with history

This raises questions about the advisability of relying on precedents. A perfectly reasonable response to the observation that 'the high yield market has never returned to its previous lows after this great a recovery' might be 'there is always a first time'.

It is true that certain recent departures from historical norms legitimately give pause to asset allocators considering a near-term commitment of capital to high yield. On the other hand, one further historical anomaly undermines a leading argument *against* acting sooner rather than later.

In the last two cycles, the trailing 12-month default rate on speculative grade issuers peaked at over 10%. Those peaks roughly co-incident with the cyclical wide points in the spread versus Treasuries. Moody's Investors Services currently projects that the default rate will again rise to over 10% during the coming 12 months, although the rate currently stands at less than 4%. Judging solely by history, the opportunity to buy high yield bonds at their cyclically widest spreads remains a year off or more, along with the projected peak default rate.

The departure from historical precedent that is relevant in this case is the unprecedented divergence of the two time series depicted in the second chart. Never before has the high yield spread risen as sharply, relative to the default rate, as in the past year. In the current cycle, the widening of the spread has run far ahead of the increase in the default rate. This may mean that even if the default rate rises by as much as Moody's forecasts, the spread will widen no more than it already has.

Other outcomes are also possible, but with the market currently in uncharted territory, it is hard to predict how today's spread versus Treasuries will be regarded in the future. In hindsight, it may mark a point from which the spread temporarily widened, instead of continuing the narrowing trend that began in December. Alternatively, the present spread may turn out to have been an excellent entry point for high yield buyers.

Again, caution regarding timing is not entirely unwarranted. After all, the US economy has been in recession for the past year and economists expect the slump to continue well into 2009. That does not bode well for corporate earnings or, in turn, for the value of debt of companies that cover their interest charges by comparatively slim margins.

This is another instance, however, in

which the historical record does not automatically vindicate the pessimistic view. During the eight month recession of 1990-1991, the annualised return of the ML Master II index was a respectable 9.23%. Investors who had not moved into high yield by then missed a 27.95% annualised return over the next six months.

The high yield index did not perform nearly as well in the eight-month recession of 2001, returning -0.68%, annualised. Breaking that figure down by industry, however, reveals that the negative return was largely a function of the collapse in the TMT (technology, media, and telecommunications) sector. Excluding that sector, the annualised return of high yield was 9.19%, nearly the same as in the previous downturn.

The question is whether a comparable concentration of credit problems in one or two industries is likely to penalise the overall high yield return during this recession. Housing, the most visible trouble spot, has already taken a beating. Homebuilders' bonds currently trade at just 56% of face value and represent only 4% of the market value of the index.

For that matter, the index itself has been beaten down severely, to 65% of face value. Consequently, there appears to be a decent chance that high yield bonds will do as well for the remainder of the recession as they did during the 1990-1991 recession and, except for the TMT sector, during the 2001 recession. The consensus forecast of economists is that the greatest GDP decline of the current downturn has probably just occurred. The road could remain bumpy for a while, but the financial markets may perhaps start to look ahead to the eventual earnings rebound.

Manager selection criteria

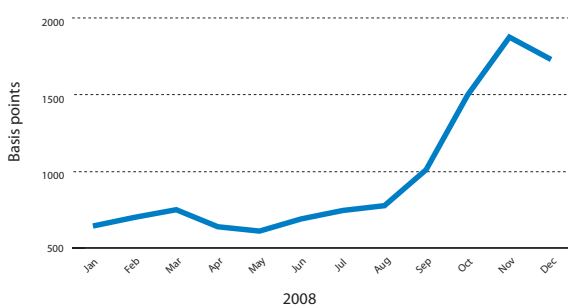
A final point for institutional investors to consider is that they can select high yield managers who share their cautious stance and are positioning their portfolios accordingly. Currently, a favoured strategy among managers who still perceive substantial downside risk is to remain high in the capital structure. They are obtaining exposure to non investment grade companies largely through secured loans. In the case of a default, these senior obligations should retain considerably more of their value than more junior, unsecured bonds. As the recession draws closer to its end, these managers can shift downward in the capital structure to prevent their clients from missing out on upside potential during the recovery.

Another way to mitigate risk is to underweight cyclical industries. Performance variances during the 2001 recession were not restricted to the telecom and cable sectors, which cratered for reasons not directly related to the general business cycle. Below-average returns were also generated in such economically sensitive industries as automobiles, chemicals, paper, and steel. Conversely, non-cyclicals such as entertainment, health care, and services delivered returns that were above average. This time, industry rotation should once again enable managers to cushion near-term risk and boost returns during the upturn, even though the specific mix of superior and inferior performers will not perfectly match past experience.

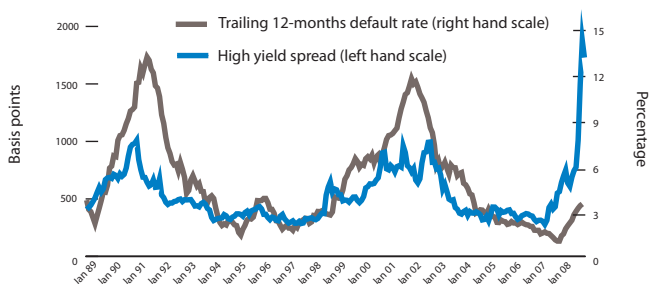
The field is littered with the bodies of those who sought to time the markets with precision. Providers of capital must always bear in mind that part of what they get paid for is the possibility of an unexpected setback to economic recovery. Along with the risk of getting in too early, though, there is a risk of getting in too late. Prudent portfolio strategies enable institutional investors to balance these risks as they assess the current attractiveness of the high yield asset class.

Martin Fridson, CFA, is CEO and co-CIO of Fridson Investment Advisors, part of BNP Paribas Investment Partners

1: High yield spreads vs US Treasuries monthly, 2008



2: Yield spread and high yield default rate monthly, 1989 – 2008



Source for both: Merrill Lynch & Co