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HIGH YIELD BONDS

FROM INVESTOR'S SAVIOUR TO THE DEVIL INCARNATE AND BACK

High yield bonds tend to conjure up images of the boom and bust 1980s, but the fundamentals for this demonised asset class are currently positive

The junk bond – also referred to as high yield or speculative grade – market has undergone dramatic swings in investor perception from the early 1980s under Michael Milken, the junk bond market pioneer, to the telecom bubble in 2001 and finally to the large inflows of investments seen in 2003.

During these swings, investor thoughts have ranged from thinking junk bonds offered no risk to believing they were created by the devil. This wide divergence in perceptions reflects a misunderstanding of high yield by a majority of both professional and individual investors.

This misunderstanding, along with market swings, explains most of the volatility in relation to perception of the high yield market. This article will elaborate on the special nature of high yield investments, on how they fit in a portfolio, and discuss the outlook for the asset class in order to provide investors with a more thorough understanding of high yield.

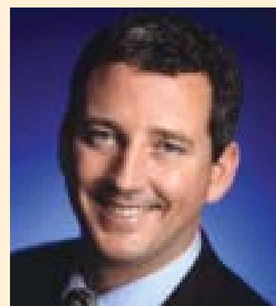
Rating agencies define high yield (HY) as credit instruments with a rating below BBB-, reflecting increased default risk and risk of principal loss. These ratings on a company are helpful and offer some transparency to bond markets. However, a "bad rating" does not necessarily equate to a bad company – only badly-managed companies are truly "bad companies".

Furthermore, these fixed income instruments should not be called "junk bonds", as this term connotates these investments are trash. Preferable is the term "high yield corporates" as it more accurately reflects that investors receive a sensible risk/reward trade off, that is, a high coupon that reflects higher financial and/or business risk often combined with lower liquidity and a more complicated corporate structure in comparison with investment-grade credit instruments.

LIABILITIES

The ranking of high yield bonds in the capital structure versus other liabilities is perhaps the most important factor for high yield investors to understand. Due to the deeply subordinated nature of HY bonds, we should not underestimate the value of asset pledges given to bank debt. On the liability side of the balance sheet we often rank only one notch higher than common stock, which means in the case of default we are the second to last to be paid with any leftover assets, right before shareholders. In addition, in European high yield structural subordination of bonds is common. Besides contractual subordination, which is standard in the HY market, many European firms issue high yield bonds at a holding company rather than at the operating firm, as it's typical in the US.

This structural subordination can result in extreme cases where high yield bonds are essentially in step with equity, rather than senior to equity as envisioned.



'The capacity utilisation of high yield firms is unconstrained and general leverage is acceptable'

Peter Walburg (left) and Gary Sullivan, DWS

BALANCING RISK

Financial risk for high yield investors refers to the ability of a company to meet its financial obligations whereas business risk refers to the risk of a business due to its underlying industry characteristics as well as the specific positioning of company within its industry. High yield companies with lower business risk can usually sustain higher financial risk and vice versa.

High yield investors must balance these risks and determine whether an issuer has the proper balance by conducting cash flow analysis to reflect these individual risks. This process involves forecasting earnings as well as fixed costs, including capital expenditures, interest, taxes, working capital, and debt payments, to determine the capacity of a company to meet these payments in both better and worse economic environments.

Although high yield bonds are bonds in the fixed income sense, they are not always affected in the same way as government bonds by the interest rate cycle. More specifically, strong economic numbers usually have

the direct effect of increasing government yields.

However, the spread between high yield bonds and government bonds decreases under most cases during economic growth, as companies are able to increase revenue, possibly margins, improve cash flow stability, and decrease debt.

All of these developments are favourable for the credit quality of the company and should reduce the required risk premium (spread) over time.

SPREADS DRIVER

The main driver for spreads is default rates for high yield bonds as the spread provides investors compensation for the potential default and a risk premium. In general, the default rate for corporates is a lagging indicator of the performance of the high yield market.

Therefore it is important to forecast the expected default rate. The main inputs for this are economic growth and the current credit quality of issuers. The ability of bond issuers to refinance their existing debt is also an important factor in forecasting the default rate.

The second driver is the performance and volatility of the issuer's equity and the equity markets in general. Many high yield bonds have listed stock, which gets valued through an exchange every day. The market capitalisation of the issuer reflects a "cushion" to high yield investors before their bonds are potentially impaired.

Naturally, stocks move with the overall sentiment of the market. However, if the equity of a high yield issuer shows a significant amount of volatility, then high yield investors see greater risk in the balance sheet of the company as a whole and demand more spread to reflect the greater probability that the "cushion" provided by the issuer's equity will decline.

Therefore, volatility in the stock market has a contagious effect on the high yield market due to the uncertainty of earnings and consequently equity valuations.

The third driver is expectations of future capital expenditure. If the capacity utilisation of a company is close to its maximum limit and profit margins are still at acceptable levels, then an increase in capacity makes economic sense to the equity investors.

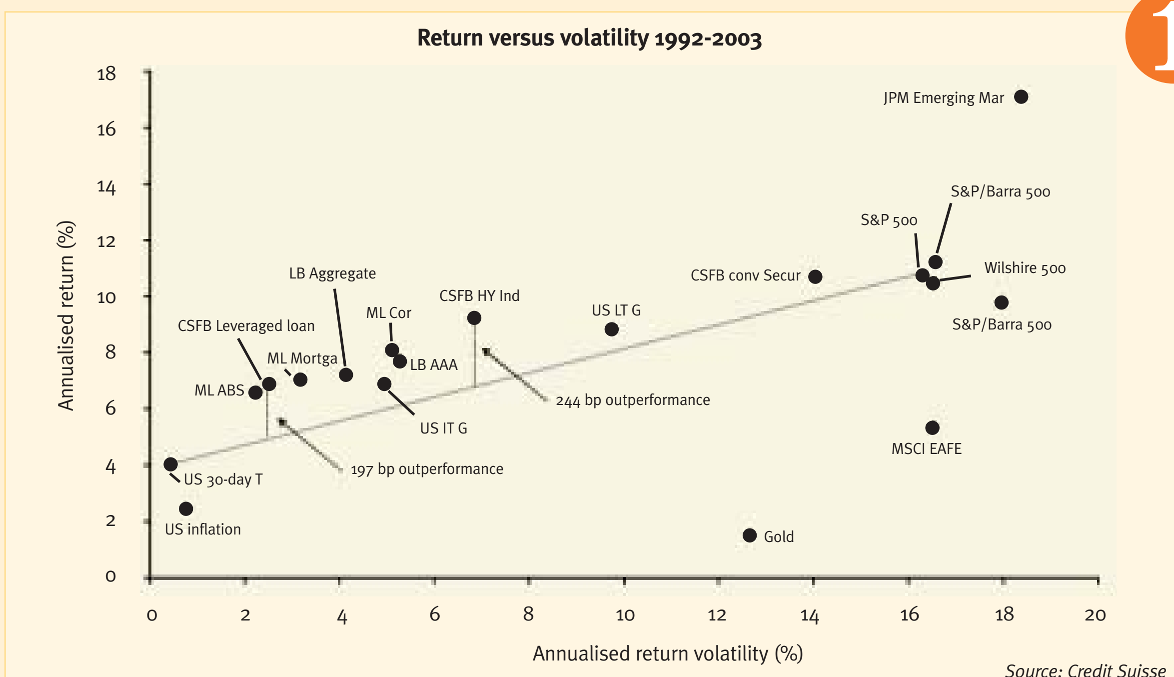
However, a high yield investor should see this as a significant warning sign because the capital expenditure is usually financed through additional debt. This additional debt then burdens the future credit quality of the observed company and causes spreads to increase.

So how do high yield corporates fit into a portfolio? Chart one shows return versus volatility from 1992 to 2003. It is interesting to note that high yield had similar returns to equity markets with much less risk. High yield also compared favourably with investment grade corporates, mortgages, and government bonds.

Markowitz efficient frontier graphs also show the attractiveness of high yield in a portfolio. A combination of high yield and investment grade corporates can increase returns with lower risks, as seen in chart two. The same is also true in chart three.

MARKET OUTLOOK

Two opposing forces drive the outlook for the high yield market. The fundamentals are positive. The default rate should continue to drift down from the current 4 per cent as measured by the Moody's trailing 12-month default rate. The US Federal Reserve should gradually increase rates and therefore not significantly increase default



Source: Credit Suisse

rates in the medium term. Furthermore, the capacity utilisation of high yield companies currently remains unconstrained and general leverage is acceptable.

On the other hand, the market technicals in the US have turned negative. Equity volatility has increased. Strong outflows from the high yield mutual funds have taken place and new issue supply has continued at a record pace. Nevertheless, there is value in current spreads and investors should take advantage of any spread widening due to technicals in order to increase their allocation to high yield.

Gary Sullivan, DWS head of portfolio management high yield. Peter Walburg, global head of fixed income research at DWS

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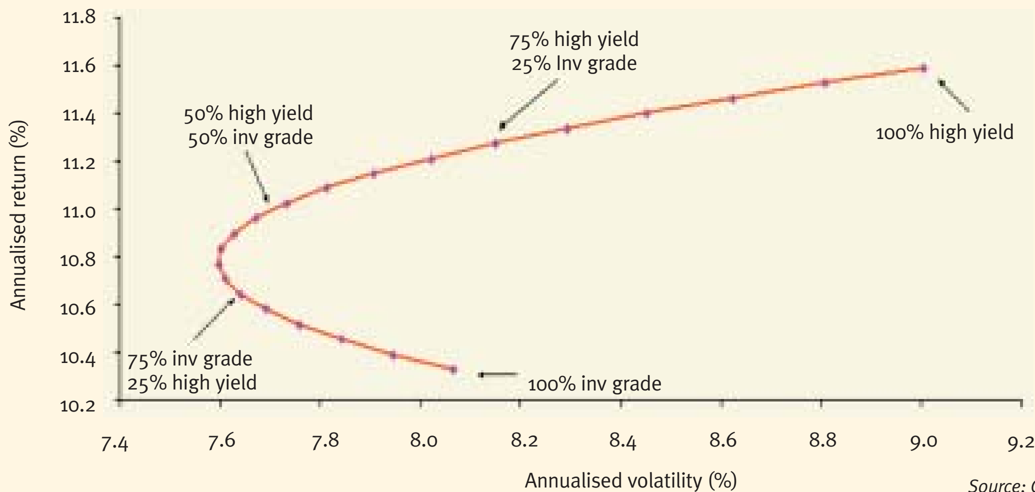
Combining high yield with investment grade corporates 1980-2003



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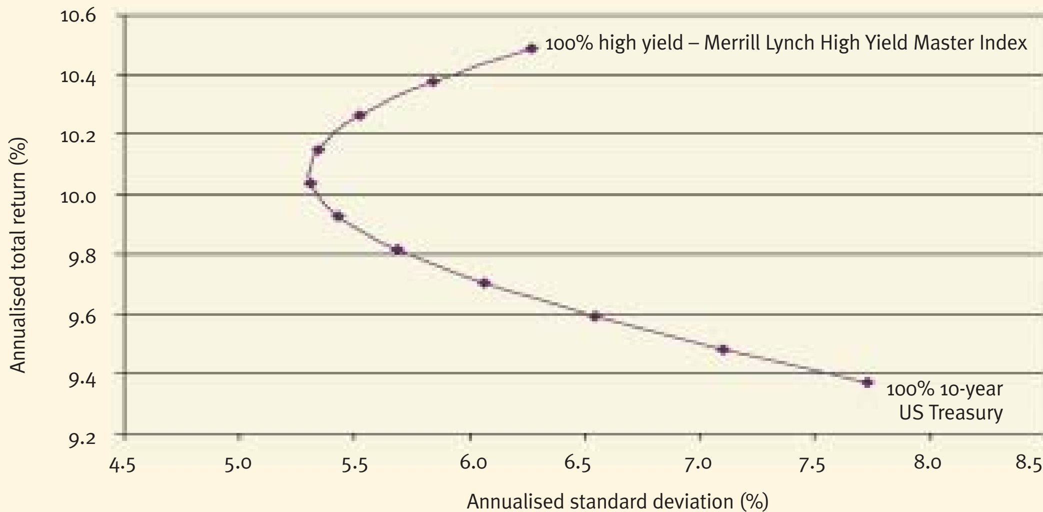
Combining high yield with 10-year treasury



Source: Merrill Lynch

CORPORATE STATEMENT

DWS Investments is the leading German mutual fund manager with a market share of 25 per cent. Managing assets of €126bn in more than 400 mutual funds, DWS-Group is also one of the leading European mutual fund companies. DWS has received numerous awards by independent experts for its superior performance record. Among these is the prestigious Standard & Poor's Fund Award as best mutual fund company in Austria, France, Germany, Spain and Switzerland.

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