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PROFESSIONAL WEALTH MANAGEMENT

SOLUTIONS FOR EUROPEAN DISTRIBUTORS

HIGH YIELD HISTORY LESSON

# A GLOBAL PERSPECTIVE PICKS OUT THE BEST FROM EUROPE

**Investors seeking alternative sources of return in today's environment of low interest rates and equity uncertainty are increasingly looking to high yield investments. To navigate this asset class, investors need an understanding of the different courses taken during prior investment cycles as well as the application of a global approach**

The past six months have witnessed dramatic inflows to high yield funds. Investors are seeking incremental yield and looking for alternatives to the uncertainty dogging equity markets. High yield is looking particularly attractive thanks to diligent corporate management and balance sheet repair. As these initiatives bear results, access to liquidity improves and strategic feasibility increases. While the current fixed income market is further along for investment grade borrowers, small to mid-cap companies that dominate the high yield universe have plenty of room to perform.

'We believe that every period of stress is followed by a recovery period typically measured in months, not years'
Roberta Goss, Goldman Sachs Asset Management

## WHY NOW?

In many ways history repeats itself, and parallels can be drawn between today's high yield environment and the experiences of the early 1990s. Understanding these parallels as well as key differences may allow investors to best exploit the high yield asset class in the coming market cycle.

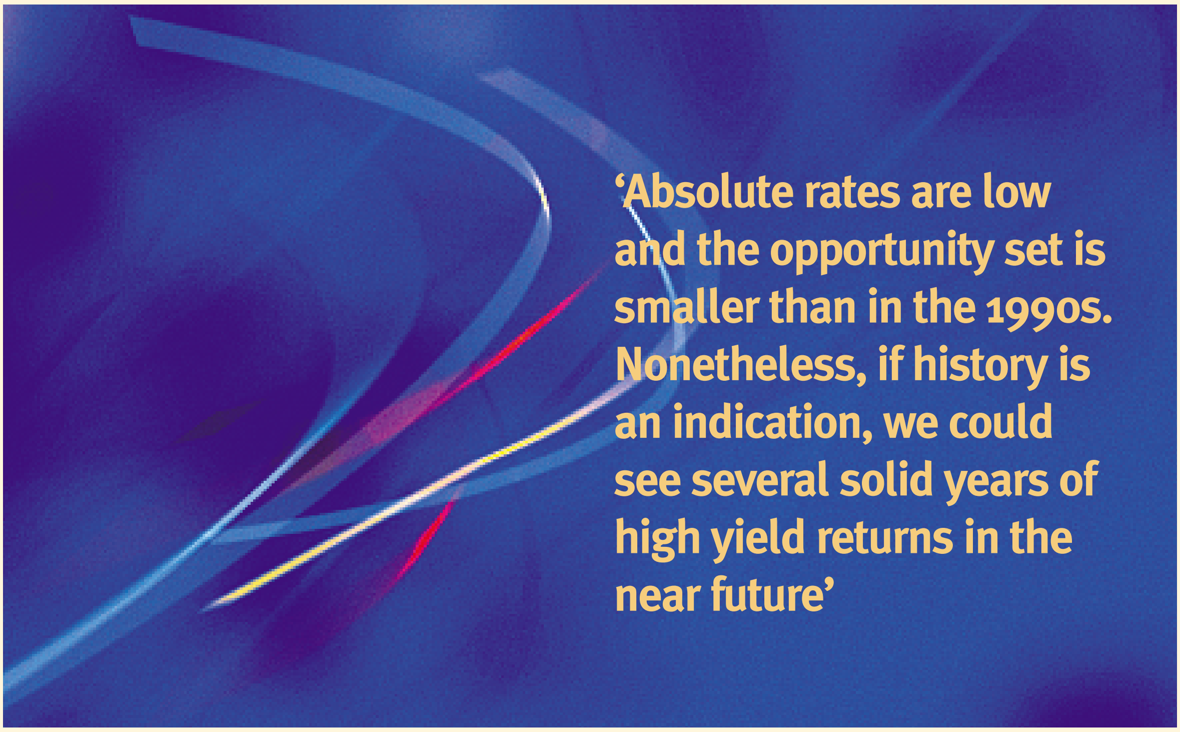
Goldman Sachs Asset Management views the dominant parallel between the markets of today and the 1990s as the significant increase in spreads. In both cases this increase results from high bond defaults and the subsequent contraction as corporations correct their excesses. In both 1990 and the third quarter of 2002, spreads exceeded 1100 basis points, far above the historical average of 400 basis points. This extreme spread dislocation is a relatively infrequent occurrence, and historically has signalled a tactical opportunity to invest in high yield.

In 1991 the high yield environment was defined by excessive debt in leveraged buyouts. This corporate fragility was compounded by the dominance of Drexel Burnham Lambert in the high yield market. Drexel's subsequent collapse in 1990 severely constrained liquidity for the asset class in a time of forced selling for savings and loans institutions.

## CULPRITS

In the more recent period, the culprit was the overly-leveraged telecommunications sector. A large number of high yield issuers were products of the growth bubble, whose underlying asset valuations could not support the weight of their over-leveraged balance sheets. When the bubble burst, recovery rates in restructuring were significantly lower than during previous cycles.

At Goldman Sachs Asset Management, we believe that every period of stress is followed by a recovery period typically measured in months, not years. There is




currently much debate about the path this recovery will take in comparison to the last cycle. In the early 1990s recovery was dramatic and resulted in super-normal returns. As corporate managements addressed their excesses, spreads tightened by more than 700 basis points (bps) and cumulative returns over the next three years were approximately 95 per cent.

Few investment professionals are predicting comparable returns over the next three years, as absolute rates are low and the opportunity set of severely stressed sectors is smaller than in the early 1990s. Nonetheless, if history is an indication, we could see several solid years of high yield returns in the near future.

## CAN IT LAST?

The current economic cycle has again witnessed a sharp contraction in spreads. From a peak of 1095 in October 2002, B-rated corporate spreads have dropped to just over 750 bps at the end of March 2003, with a corresponding return of approximately 15 per cent. But will the rally last?

Even at these levels, spreads are unusually high, particularly when compared with investment grade and other fixed income benchmarks. Over the medium-term, we believe that high yield spreads are likely to migrate back to historic trend levels in the 400-450 bps range. This should again create the opportunity for strong outperformance relative to other fixed income asset classes.

At Goldman Sachs Asset Management, we believe that the main driver behind this spread contraction will be catalysed by ongoing balance sheet repair. As companies dispose of assets and benefit from general economic improvements, liquidity positions and access to the refinancing markets will improve. We expect this to translate into a rapid decline in the default rate, as was the case in the early 1990s when the rate peaked at 8 per cent and then dropped to around 2 per cent in the following two years.

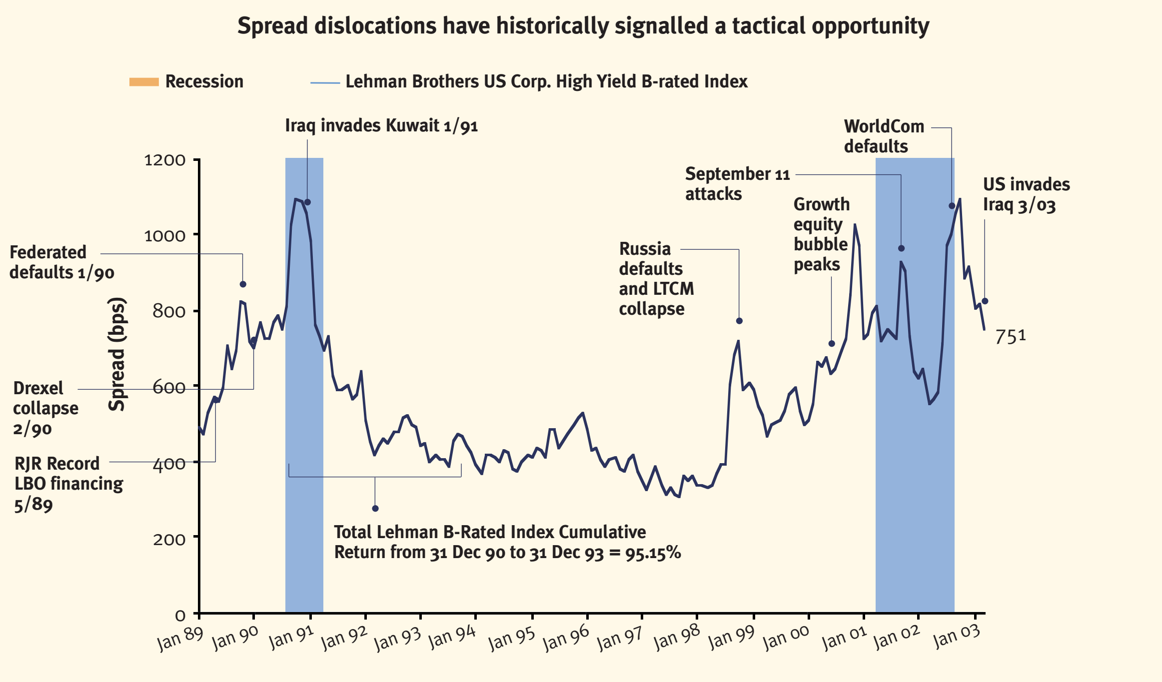
The recent economic cycle has seen dollar weighted default rates peak at 15 per cent in the third quarter of 2002, with large "fallen angels" such as WorldCom responsible for a great deal of the difference. According to Moody's, the number of issuers defaulting was similar. Since then, default rates have declined sharply and are estimated to lie between 5–7 per cent in 2003. In fact, during the first quarter 2003 default rates were approximately 1.25 per cent.

This should provide the opportunity for high yield securities to generate solid returns in the months and years ahead.

The implication is clear: the most significant way for managers to outperform is to avoid defaults. In other words, the most important decision a high yield manager can make is the decision not to own a credit.

## WHY GLOBAL?

At Goldman Sachs Asset Management, we believe taking a global perspective increases the opportunity to achieve higher risk-adjusted returns through a greater opportunity set and increased diversification.



Source: Lehman (Market Returns, Spreads)

### Greater Opportunity Set

When considering whether to invest in high yield, it is critical to look at opportunities in both the European and US high yield markets together. The US market is by far the largest, most developed high yield market in the world at over $850bn in size. The European market in contrast is a fraction of the size at less than 10 per cent. The current composition is dominated by “fallen angels”. While the European market is very dynamic, it is also markedly less liquid and more volatile.

### Increased Diversification

The primary consideration when analysing high yield is to ensure diversification. This can be achieved only by combining European and US opportunities. For example, the European high yield market’s development during the recent growth bubble resulted in technology, media and telecommunications representing nearly 80 per cent of new issuance at its peak. Not surprisingly, this sector concentration was equally responsible for the region’s dramatic underperformance over the past five years and accounts for the 46 per cent default rate experienced in 2002 (over three times that of the US). The European market should therefore be viewed as part of an integrated global strategy and not in isolation.

## KEYS TO SUCCESS

**Robust teams:** Capturing global opportunities requires a focused team of experienced credit specialists to select the best credits from both European and US markets while developing a broadly diversified portfolio.

Successful managers will have an expanded team of analysts demanding access to management and ensuring effective counterpart execution.

**Detailed credit analysis:** The assessment of credit risk globally should be an extension of fundamental bottom-up industry and company analyses. In this sense, credit risk in high yield can be viewed as similar regardless of country or legal frameworks and regardless of currency denomination.

**Manage currency risk:** High yield investors would be well served to avoid currency risk through hedging in order to separate the credit alpha from currency risk, which can otherwise be a dominant factor in returns.

We suspect that those managers that capitalise on a global opportunity set will be best positioned to capture opportunities and avoid pitfalls as the current cycle plays out.

## CORPORATE STATEMENT

**Goldman Sachs is one of the leading global investment banking, securities and investment management firms that provides a full range of services worldwide to a diversified client base including corporates, financial institutions, governments and high net worth individuals. Founded in 1869, it is one of the oldest and largest investment banking firms. Goldman Sachs Asset Management was founded in 1988. Globally, the firm manages assets totalling some $309.2bn as at December 31 2002.**

Goldman Sachs Asset Management

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