May 25th, 2005
Volume 4, Issue 3

Intelligent Money

Current thinking from Haven Financial Advisors

Louis Kokernak CFP, CFA
Haven Financial Advisors
Austin ~ Dallas
voice 512 514 6250
toll-free 800 898 5480
fax 800 888 5480
louis@havenfinancial.com

Special Notes of Interest:

- Since early March, the average spread of emerging market bond yields over US Treasuries has risen by almost 0.50% compared to 1.80% for high yield corporate debt.
- The largest spread of high yield bonds to treasuries was 11.17% in December 1990. This was in the midst of a recession

GM's Downgrade and High Yield Debt

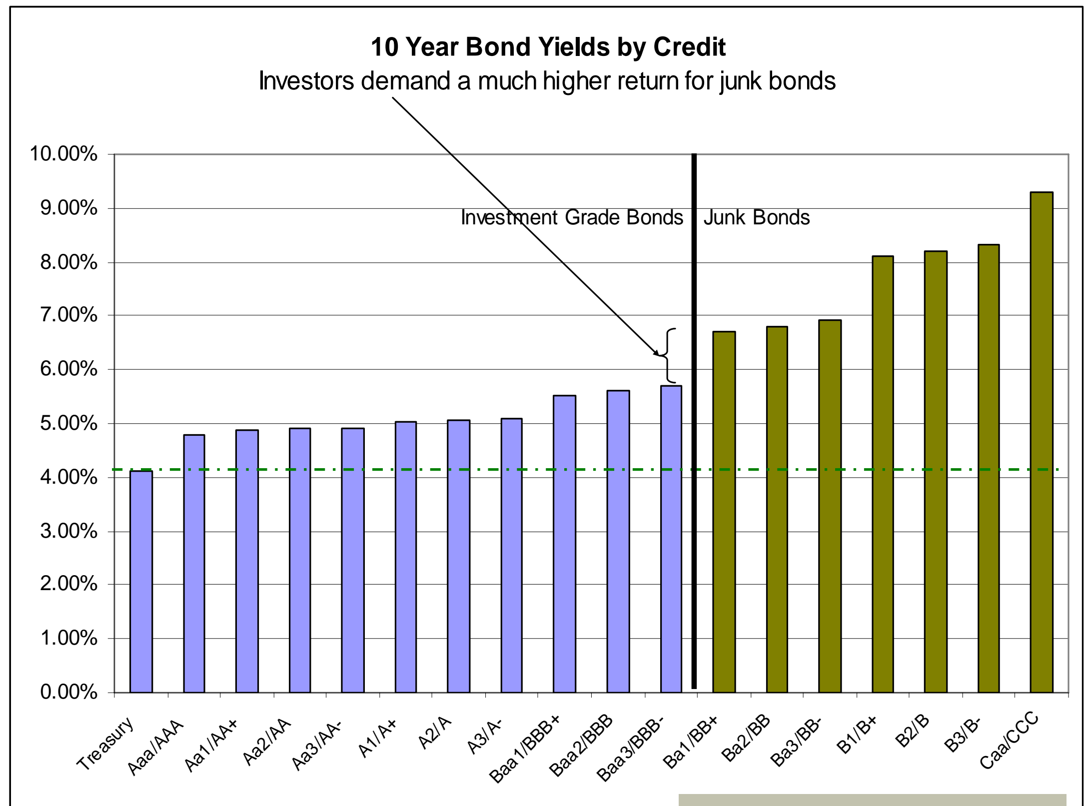
On May 5th, Standard and Poors downgraded the debt of General Motors and Ford below investment grade status. This has had significant repercussions in American debt markets. Together, these two borrowers have issued $400 billion of bonds. GE is the only company that has issued more. Were they added to a junk or high yield bond index, they would materially alter the mix of issuers represented therein.

Relegation to junk bond status is a significant event in corporate finance. The chart below, compiled from mid May data, shows that investors demand more than 1% in extra return from the highest junk rating (BB+) relative to that required of the lowest investment grade bond (BBB-).

High yield debt markets were once comprised almost exclusively of fallen angels. These were companies who credit ratings had declined from once lofty levels.

In the 1980s, Michael Milken put the investment firm of Drexel Burnham Lambert on the map as his team effectively created a marketplace for high yield original issue credit. Capital intensive companies comprised the lion's share of this new marketplace. For most of the 1980s and 1990s, high yield debt exceeded comparable treasury interest rates by 3% to 4%. That is still true today. In the aggregate, junk bonds yield about 7.5% while intermediate treasuries hover around 4.00%.

While the high yield market was once the exclusive province of American issuers, Europeans have entered this market in force in the 21st century. They now comprise



High Yield Debt (Cont)

about one sixth of its issuers.

There is a classic tradeoff between risk and return in the bond market just as there is in the stock market. Third party rating agencies assign credit ratings to corporate and sovereign issuers so that investors have a general sense of the safety of their investment. There is a direct relationship between the interest rate demanded by the market and the credit quality of the issuer.

While junk bonds offer more interest, their default rates are higher. In fact, most analysts believe that the price behavior of junk bonds shares characteristics with both treasury notes and the stock of the underlying issuer. Makes sense – in that the danger of default is closely associated with the issuers ability to generate cash flow.

"Investors demand more than 1% in extra return from the highest junk rating (BB+) relative to that required of the lowest investment grade bond (BBB-)"

Apart from credit risk, junk bonds often have aggressive call features. These allow their issuers to call them away from investors if there is a decrease in interest rates or an improvement in credit quality. Many junk bonds also have little to no secondary market. They're simply hard to sell.

These risk factors together have made junk bonds somewhat more volatile than treasury bonds of similar maturity. On a risk adjusted basis, it is an open question whether they offer superior returns to treasuries. Recent tax law changes have also made dividends more attractive relative to the interest that these bonds pay. The historical evidence indicates that junk bond prices are adversely affected by economic slowdown. They are allergic to recessions.

"Nearly 40% of the emerging markets universe is now investment grade."

	Moody's	Standard & Poor's	
Highest Quality	Aaa	AAA	Investment Grade
High Quality	Aa	AA	
Upper Medium	A-1, A	A	
Medium	Baa-1, Baa	BBB	
Speculative	Ba	BB	Not Investment Grade
Highly Speculative	B, Caa	B, CCC, CC	
Default	Ca, C	D	

That having been said, junk bonds offer conservative investors with income needs a relatively easy way to obtain distributions. Moreover, the equity component of junk bond should reduce the overall risk of a portfolio otherwise dedicated to fixed income. In short, we believe that "junk" can play a useful role for some investors requiring current income.

Recent economic data has been encouraging for bond investors. Defaults by companies on bond debt — meaning when firms fail to pay investors what they're owed — have been rare in the last two years. In the first four months of this year, 10 companies defaulted on $2 billion of bonds, according to credit rating firm Moody's Investors Service. In the same period last year, 14 firms defaulted on $2.5 billion. That is a small fraction of a junk market worth nearly $500 billion (excluding GM and Ford). On a related note, Fitch ratings noted that high yield issuers have greatly expanded their earnings and cash balances relative to outstanding debt since the latter half of 2003.

The market for emerging market debt is closely associated with junk bonds. Until recently, most emerging sovereign issuers had junk credit ratings. Moreover, the required yield of sovereign issuers was substantially higher that comparable corporate credits in the US. This is changing rapidly. Nearly 40% of the emerging markets universe is now investment grade. Secondly, emerging market yields are approaching those of corporate issuers of similar credit. The spread between emerging market debt rated BBB (the lowest investment grade) and equivalent corporate bonds has fallen from 0.50% in early April to 0.00% today.