INSIGHTS

High Time to Invest in High Yield Bonds

With spreads at all-time wides, high yield bonds offer compelling risk premiums

Summary

- Throughout history, some of the best investment opportunities have emerged during times of market turmoil.
- We believe that high yield bonds, with their low correlation to other asset classes and potential for equity-like returns, currently offer a value opportunity for investors.
- With spreads between high yield bonds and Treasuries widening to record levels (more than 1,400 basis points in October 2008), we believe now is a good time for investors to consider a long-term allocation to high yield.
- In our opinion, current spreads imply an overly pessimistic view of default among high yield bonds and leveraged loans. While defaults are expected to rise significantly from current lows, we do not anticipate this rate will increase to a level justifying current spreads.
- We believe issuers in the high yield market are, in general, reasonably well positioned to withstand the economic downturn.

High yield bonds: an introduction

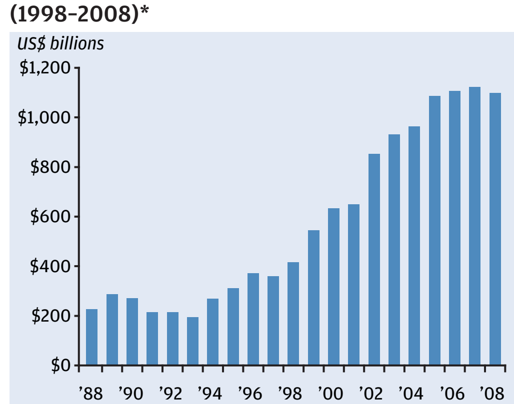
High yield bonds play an important role in a fixed income portfolio. Defined as corporate debt obligations rated BB+ or lower (using Standard & Poor's scale) or Ba1 or lower (using Moody's rankings), high yield bonds typically offer investors higher interest rates than Treasuries or investment grade bonds due to their greater risk of default. Commonly referred to as "below investment grade" or "junk" bonds, high yield bonds generally have a low correlation to other sectors in the fixed income market and can enhance portfolio diversification. High yield bonds also hold the potential for capital appreciation in the event of a rating upgrade, an economic upturn or improved performance at the issuing company.[1]

Over the past ten years, the high yield market has grown considerably, increasing from just over $200 billion in 1998 to more than $1 trillion in 2008 (see **Exhibit 1**). Broadly speaking, corporate issuers of high yield bonds are either former investment-grade companies whose debt has been downgraded, or smaller, less well-established and/or highly leveraged companies.

As with all investments, there are risks associated with investing in high yield bonds. Key risks include:

- Default risk—the risk that the company issuing the bonds may fail to make scheduled interest and/or principal payments
- Principal risk—the risk that the holder may lose the amount invested (i.e., principal) due to bankruptcy or default
- Downgrade risk—the risk that a credit agency may downgrade the bonds due to an issuer's deteriorating financial health, which will in turn reduce the value of the bond.

Exhibit 1: Growth of the high yield bond market (1998–2008)*



* Data as of September 30, 2008.
Source: Federal Reserve, Merrill Lynch estimates. The above information is shown for illustrative purposes only.

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November 2008

[1] Similarly, high yield bonds can depreciate in value and this is often linked to a ratings downgrade, an economic slowdown or poor performance at the issuing the company.

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A market of opportunity

An interesting anomaly currently exists within the high yield market: spreads between high yield bonds and Treasuries have widened enormously, but defaults have remained at below-average levels. This trend is noteworthy as spreads and defaults historically move in tandem, with defaults edging higher whenever the macroeconomic picture weakens and corporate profitability deteriorates.

To date, however, this hasn't happened. At the end of October 2008, spreads between high yield bonds and Treasuries were trading at record wides of more than 1,400 basis points (see **Exhibit 2**). Default rates, meanwhile, remain below average at 3.1% (based on issuers) and 1.3% (based on dollar volume), due to low refinancing requirements, flexible debt terms and solid corporate cash flows.[2]

High yield bonds are attractively priced in the current market

Although defaults are expected to rise significantly in the next year, current spreads are compensating for levels far beyond projections. According to Moody's estimates, the issuer-weighted Global Speculative Grade Default Rate is projected to rise to 4.2% by the end of 2008 and to 7.9% for the 12 months ending September 2009. The dollar-weighted default rate, meanwhile, is predicted to rise to 2.3% by year-end and to 6.5% in 2009.[2] Current spreads, in contrast, are factoring in a default rate of 17% (see our calculations in **Box 1**), over two times the Moody's estimate and a level not seen since the Great Depression.

Box 1: Sizing up today's risk premium

High yield investors traditionally look to earn a 300 basis point long-term risk premium above risk-free Treasuries, assuming no defaults.

The probability of default adds an excess spread for losses. If high yield bonds are yielding 1,400 basis points over Treasuries, this implies an excess spread of 1,100 basis points or 11.0%.

Assuming that, in the case of default, you are likely to recover 35% (35 cents on the dollar)—i.e., lose 65%—a 1,100 basis point excess spread implies a 17.0% default rate (17.0% x 65% = 11.0%).

Example*

Current spread to Treasuries	14.0%
Less long-term risk premium	– 3.0%
Excess spread for losses	11.0%

Excess spread = (1-Recovery rate) x **Default rate**

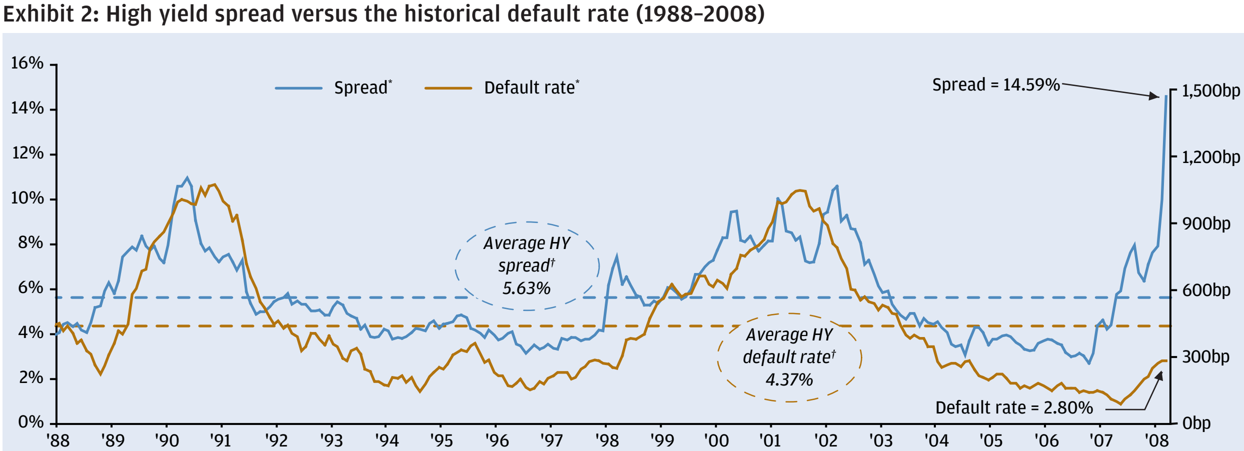
11.0% = 65% x **Default rate**

Default rate = 17.0%

* For illustrative purposes only

While we expect overall economic conditions and company profitability to weaken and default rates to increase for the next twelve months, we believe the market has overreacted to what we see in terms of economic and corporate fundamentals. As a result, we believe value can be found in the high yield market place.

Exhibit 2: High yield spread versus the historical default rate (1988–2008)



Sources: Credit Suisse, Moody's.
* Credit Suisse High Yield Index Spread. Data as of October 30, 2008
** Moody's Investor Services. Data as of September 30, 2008
† Average is for period represented.

[2] J.P. Morgan estimates

Determining an entry point

Historically, spreads widening to 1,000 basis points have been considered an opportune time to invest in high yield. Investors who have entered at this point in the past have been rewarded with strong risk-adjusted returns over the following 12-month period. An investment in high yield debt following October 1990, when spreads peaked at 1,060 basis points, for example, achieved a one-year return of 45.12%; returns for the 12-month period following September 2002, when spreads peaked at 1,070 basis points, totaled 27.17%.[3]

With high yield bonds attractively priced in the current market, and bondholders being well compensated for the risk they are undertaking (especially considering the modest default rate), now could be an advantageous time to invest. Furthermore, we believe high yield bonds will offer equity-like returns once the market corrects.

Spreads widening beyond 1,000 bps have historically been considered an opportune time to invest

Using history as a guide, we believe today's market conditions bear similarities to 1990–1991, when consumer confidence was weak, housing was soft, and the overuse of leverage resulted in a market meltdown (see **Box 2**). During that period, spreads rose above 1,000 basis points and both high yield returns and defaults subsequently soared to record levels.

We believe today's high yield market, though similar, is unlikely to see the same levels of default, despite recent failures in the financial markets. The high yield market is five times larger ($1 trillion) and more diverse by business sector than it was in 1990–1991. In most cases, corporate borrowers are coming from a stronger position relative to those in past downturns, with better balance sheets and greater financial flexibility. These companies are generally more profitable and have long-term financing agreements in place (which include relatively low interest rates and generous terms). In addition, today's high yield issuers are generally larger, have stronger business models and can generate cash more easily than past participants.

For these reasons, we believe companies issuing high yield debt are better equipped to handle the current economic conditions and should perform strongly over the medium term.

Box 2: Learning from history

To gain greater perspective on today's market, it is worth examining the recession of 1990–1991, where high yield spreads widened substantially.

The credit crunch that began in July 1990 and ended about eight months later was brought on by bank insolvency, rather than a bursting real estate bubble. The downturn was precipitated by banking regulations related to the savings and loan bailout that discouraged banks from lending. It was also exacerbated by several external factors such as the Persian Gulf crisis, the savings and loan collapse, and continued job cuts. The Drexel Burnham Lambert junk bond collapse signaled the low point of this period of excessive risk taking.

More than 25% of the high yield market during 1990-1991 was distressed and defaulted debt.* During this period, credit spreads over U.S. Treasuries for B-rated securities widened from about 550 basis points to about 1,000 basis points. The peak to trough lasted about 27 months.

The recession was one of the mildest on record, with the economy making a "U-shaped" recovery (instead of the more dramatic V-shaped bounce). During this period, the Fed reduced interest rates from 8% to 6% (well above today's 1% Fed Funds Rate).

Interestingly, 1991 was a record year for high yield bond returns and defaults. During the year, high yield bonds returned 46.2%, while defaults skyrocketed to almost 16%. The anomaly of the highest default rate and one of the highest rates of annual return occurring simultaneously was due to the bond market's forward-looking nature. In 1991, the high yield market was forecasting a sharp economic rebound from the recessionary lows.

Although the market conditions of 1990–1991 look and feel much like today, some important differences exist. Namely, the high yield market is now much larger, more liquid and consists of companies with more solid fundamentals. Therefore, we do not anticipate defaults to rise to the same levels seen during that period.

* J.P. Morgan estimates.

[3] Total returns stated assume that an investor bought the market the month following each of the stated dates and held it for one year. Past performance does not guarantee comparable future results. Total return assumes the reinvestment of income.

Bargain hunting in a battered economy

In our view, the economic weakening we are currently experiencing is being felt primarily on the consumer level, not the corporate level. As a result, we are underweight the sectors most exposed to a softness in the consumer, including consumer cyclical, gaming, retailing, and consumer discretionary companies.

Areas where we are seeing opportunities include food and beverages, healthcare, energy, telecommunications and parts of the media business. In general, we are focusing on defensive or non-cyclical sectors which are less sensitive to economic volatility.

To enhance our portfolios, we are taking lower leveraged positions and adding higher quality BB- and B-rated bonds. We are also investing in secured loans, which enable us to protect our portfolios from rising interest rates. These bank loans have floating-rate coupons, are secured by an issuer's assets and have priority over other creditors in the event of a default.

Distressed debt opportunities

As the credit crisis has deepened, a record number of high yield bonds have begun trading at distressed levels. Distressed debt investing involves purchasing the debt of companies experiencing financial and/ or operational difficulties. Some of these companies may have defaulted on their debt, be on the brink of default, or be operating under bankruptcy protection. The debt of such companies often trades at a significant discount or at very high yield, or both. These deep price discounts, along with the coupon income from performing distressed securities, can provide investors with attractive risk-adjusted returns.

Historically, periods characterized by a slowing economy, declining corporate earnings, softening equity markets, and increasing defaults have generated the best opportunities for purchasing distressed debt.

We believe today's frozen credit markets, mortgage meltdown, inflationary pressures, volatile commodity prices and currency fluctuations are producing increased opportunities in the distressed space. In the recovery phase of the last two economic and market cycles (1991 and 2003), distressed debt offered extremely attractive returns as asset prices rose and credit spreads tightened from wide levels.

During 2008, several industries have experienced significant levels of financial or operating distress, or bankruptcies. These include financials, airlines, certain media sectors, auto and auto parts, paper and forestry products, plastic packaging, housing and building products. As more companies face difficulties repaying or refinancing their debt in the current market environment, we believe additional opportunities will arise.

In general, we believe the best opportunities in distressed debt today are in secured bonds and loans of distressed issuers. The focus of our investing will be on well-secured leveraged loans trading at large discounts.

Our capabilities

Through our New York and Columbus fixed income platforms, J.P. Morgan Asset Management offers investors the choice of two high yield products. Managed by independent teams, each with their own unique investment process, these products seek to provide investors with consistent superior risk-adjusted returns.

Bottom-up security selection is central to each approach, with fundamental research forming the cornerstone of both investment processes. Our in-depth analysis focuses on the business prospects, financial condition, management, capital structure and capital requirements of each issue or issuer, and enables our teams to identify under or over-valued securities within the market.

Both strategies seek to generate well diversified, optimally constructed portfolios that outperform the benchmark over a typical business cycle.