

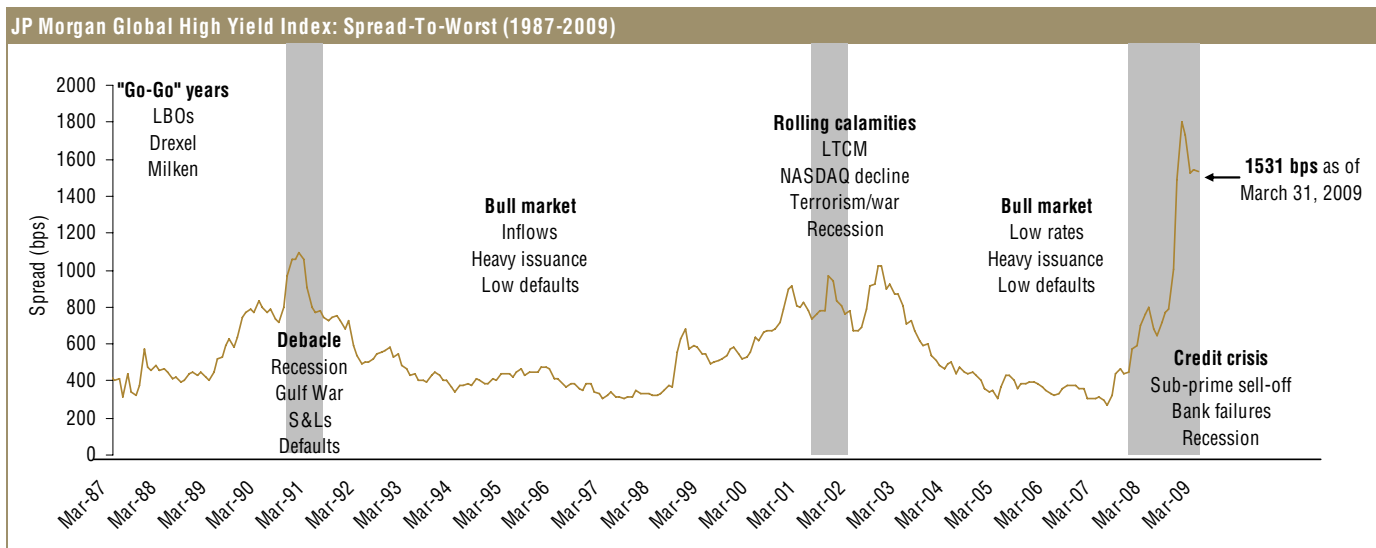
Credit Ratings and a Better Way to Manage High Yield Bonds

"In everything, the ends well defined are the secret of durable success."

– Victor Cousins

For investors in corporate bonds, the traditional measure of idiosyncratic risk has always been an issue's credit rating, as assigned by Standard & Poor's, Moody's, or another of the nationally recognized credit rating agencies. Investors wishing to take less risk and sleep better at night simply limited exposure to lower-rated bonds in their portfolios. While never entirely foolproof, this ratings-based investment approach worked fairly well over longer periods of time – until recently.

The objective in reducing risk is, of course, to sustain fewer losses and enjoy better, or at least more stable, investment results. With the current credit crisis and increase in corporate defaults, however, an approach focused exclusively, or even largely, on agency credit ratings has led, somewhat contradictorily, to more significant losses and poorer investment results. A better approach to managing risk in high yield bonds – and, at the end of the day, to producing better returns from the asset class – may be deep fundamental industry analysis. Of course, any industry-based approach must be accompanied by careful company analysis and skilled security selection – always the sine qua non of success in managing the asset class.

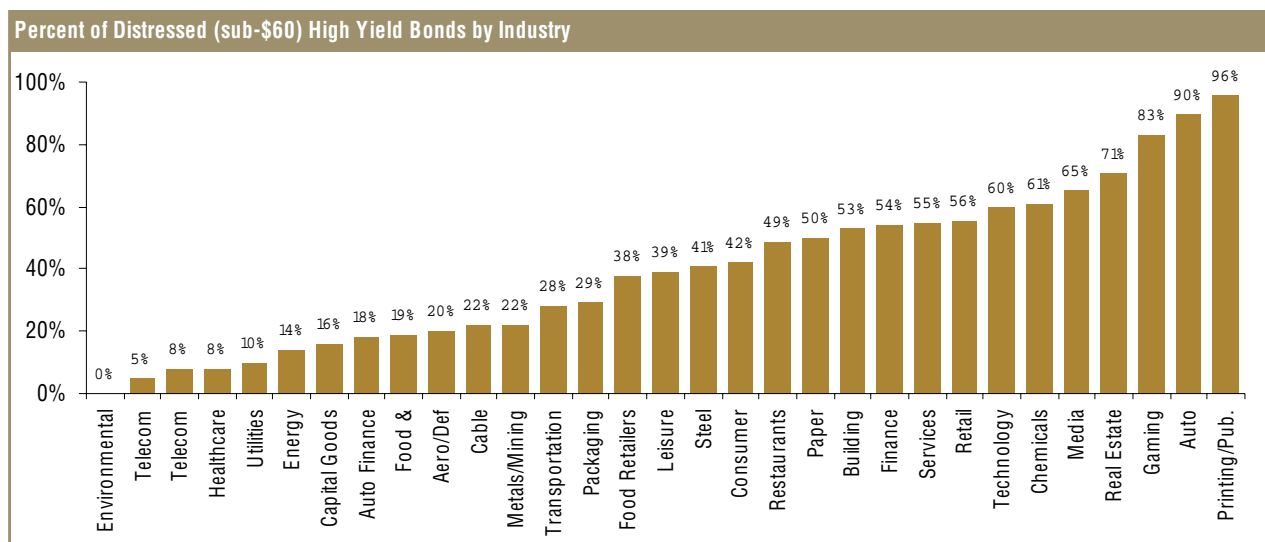


Calendar 2008 was not a particularly good year for the credit rating agencies. Lehman Brothers was rated A2/A just prior to its sudden filing for bankruptcy. Was Lehman's investment-grade rating reflective of its risk? And how about AIG's Aa3/A+ credit rating? At the other end of the scale, Centennial Communications is a high-yield-issuing wireless company currently being acquired by AT&T. While Centennial's bonds are rated Caa1/CCC+, AT&T plans to honor covenant call provisions and pay off bondholders at a price above par. Is Centennial a risky credit? Or is it simply a low-rated credit whose place in a consolidating industry made it an acquisition target and thus reduced its risk? Bond investors will often say, "I want to avoid CCCs altogether" when what they really mean is, "I want to take less risk." The two are not the same, and – as we're learning all over again in this credit cycle – a AA credit can sometimes involve more risk than one rated CCC.

A better way to avoid losses and improve returns in high yield portfolios is to focus on industry analysis – on adjusting agency credit ratings for the dynamics of the particular industry in which a company operates. Different industry sectors exhibit vastly different degrees of business uncertainty. Some display a wide distribution of potential outcomes (risk), while others afford more well-defined prospects, better clarity, and more predictability. The semiconductor industry, for example, has historically offered very poor visibility regarding the future. Consumers’ fickle preferences for electronic products are well known, and most semiconductor companies are pleased if they can project market trends even three months into the future. Not surprisingly, the semiconductor industry suffers through prolonged periods of earnings uncertainty, which translate into higher risk of bad outcomes and thus higher volatility of bond prices and portfolio returns. By contrast, companies in the telecommunications industry are better able to anticipate demand for their products, which makes their earnings more predictable and their bond prices more stable. This higher level of industry certainty reduces the risk of telecommunications companies; it also suggests that bond managers may want to adjust their own ratings for the particular industry in which a company operates.

To some extent, professional investors in high yield (a.k.a. “the market”) already make these adjustments in their trading and pricing of securities. Rather than blindly accept the agencies’ ratings, sophisticated market participants will punish a particularly risky credit and drive down its price to levels widely referred to as “distressed,” a term variously defined but most commonly as bonds trading at prices below \$60. Back in June of 2007, very few bonds traded at distressed levels, and the entire high yield bond market traded at a spread of just under three percent over US Treasuries. Less than two years later, however, at the end of April 2009, the entire high yield market traded at a spread of 17.5% over Treasuries, and more than a third of all high yield bonds were priced below \$60.

As a thought exercise and with the benefit of perfect hindsight (our favorite kind), we consider the experience of two hypothetical high yield bond managers required to build portfolios for new clients during the summer of 2007. The first manager excluded (or was required to exclude) all bonds rated CCC, in hopes of minimizing potential credit losses for the client. The second manager, by contrast, took a market weight in CCCs and focused instead on avoiding cyclical industries like autos, paper, building products, retail, and a handful of others. By the end of April 2009, more than a third of the first manager’s portfolio consisted of bonds trading at distressed levels, or at prices below \$60. In comparison, the second manager’s portfolio, even though it contained a market weight in CCCs, had fewer than 14% of its holdings priced below \$60. Back in June 2007, distressed levels and thus yield spreads were essentially the same across all industries – very low and flat. By the end of April 2009, however, both yields and distressed levels were elevated and varied widely by industry.



Source: Merrill Lynch, as of March 2009

Bond Market Observations



May 27, 2009

Clearly, no high yield bond manager has perfect foresight when it comes to assessing industry risk. But this is not the point. The point is simply that over-reliance on agency credit ratings is a poor way to manage risk and to improve returns in high yield bond portfolios, either in absolute or in risk-adjusted terms – and also that rigorous industry analysis can be a far more powerful tool for accomplishing both.

Neither the two-manager example nor the chart above takes into account the potentially positive contributions from security selection, which can improve investment results still further. For example, in the bar chart above, a single very large issuer actually accounts for all 22% of the distressed bonds in the Cable sector: Charter Communications. A manager conducting thorough company analysis and careful security selection might have kept Charter out of the portfolio altogether, thus further reducing distressed levels and improving portfolio returns.

The last two years have severely tested all risk models and investment processes. Most have been unsuccessful. Even in the midst of the current credit crisis and the increase in defaults, avoiding the bonds rated lowest by the credit rating agencies would not have protected investors nearly as well as avoiding certain highly leveraged or economically cyclical industry sectors. Institutional investors often describe their investment goals in terms of “maximizing return for a given level of risk.” In the world of high yield bonds, we can think of few strategies better suited to meeting these goals than rigorous industry analysis and careful security selection.

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