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High Yield – Still a Case for the Asset Class

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2009 Recap

The High Yield bond market generated truly exceptional returns in 2009 with a record calendar year return of +56.3% for the Merrill Lynch US High Yield Cash Pay Index, easily surpassing the prior record of +34.6% set in 1991. Spreads tightened by approximately 1100 basis points during 2009 as prospects for the economy and declining defaults rates improved. As dramatic as the sell-off was in 2008 (-26.2%), the recovery in 2009 may be equally as remarkable. Calendar 2009 was also a record year for High Yield new issuance with nearly $153 billion of US denominated issues being priced.

While this recovery can be characterized as impressive and even astounding, it would be inappropriate to characterize it as unwarranted. In fact, it can be easily explained by considering the rather dramatic improvement in the investing environment coupled with record wide spreads in the High Yield market at the beginning of the year. In December of 2008, the High Yield market was discounting default rates approaching 20% due to an impaired banking sector, limited access to capital and a recession of unknown length and depth. The application of unprecedented stimulus and government intervention resuscitated the banking system and quickly improved access to capital. Additionally, the recession ended up being shorter than feared and default rates were lower than anticipated. As a result of improving prospects, spreads tightened to more normal levels, generating record returns.

2010 Outlook

With respect to High Yield valuations and the prospects for 2010, a firming economy and a declining default rate suggest the fundamental underpinnings remain adequate. As such, we remain constructive but with tempered expectations. Whereas 2009 returns were comprised primarily of capital appreciation, we anticipate returns going forward to be comprised primarily of yield. That said, we think High Yield offers attractive relative value, particularly when compared to other fixed income asset classes.

A common concern is the prospect of higher interest rates and their impact on fixed income securities. As we know, higher interest rates are generally not good for fixed income securities. However, while higher interest rates do affect High Yield securities, High Yield bonds are considerably less sensitive to interest rates when compared to other fixed income securities. This is true for two primary reasons. First, a larger component of a High Yield bond's return comes from current income which can reduce the overall volatility of returns. Note that principal can remain volatile but the income component is current and can be reinvested at higher interest rates.

High Yield securities often experience significant spread tightening when interest rates rise, which can more than offset the impact of higher interest rates. Higher interest rates generally result from inflationary pressures which usually coincide with an expanding economy. In such an environment, companies can increase revenues, increase earnings and improve their credit profile resulting in credit upgrades. In such an expanding economy, default rates also tend to decline as a result of earnings growth. As a result, the risk profile of High Yield securities improves and the risk premium of High Yield securities (i.e. spreads) contracts. Often, the amount by which spreads contract is greater than the rise in interest rates, potentially resulting in capital appreciation and attractive relative returns.

This scenario has certainly been evident in recent interest rate cycles. The following depicts High Yield performance in the last seven major periods of rising interest rates and compares them to the return of the ten year treasury. Note that High Yield outperformed in all periods except one. Further, the outperformance of those six years was quite significant while the one year of underperformance was rather modest.

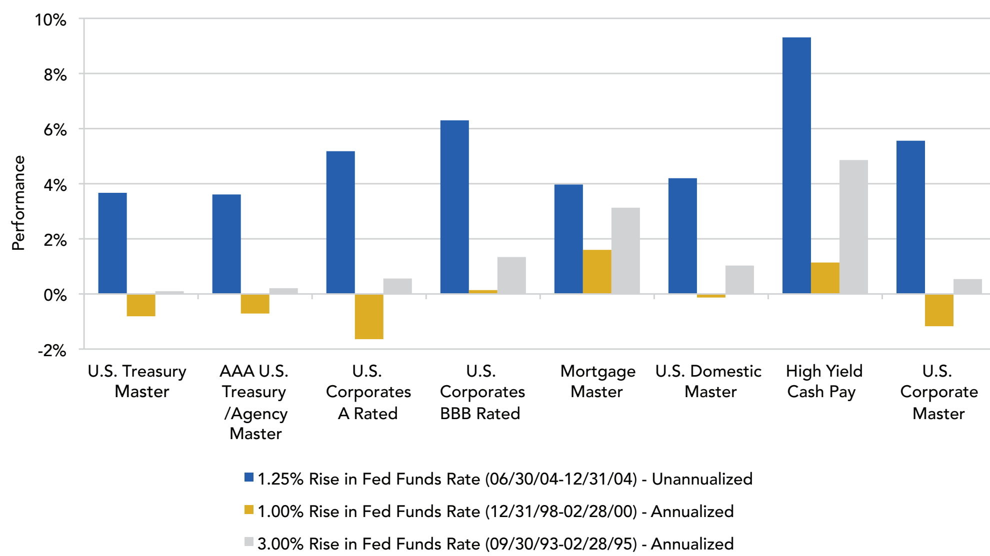
Historical Total Return Comparison
Worst Performing 7 Years for 10 Year Treasuries Since 1980

Year	High Yield Bonds[1]	10 Year Treasuries	Difference
2009	56.28	-9.71	65.99
1994	-1.16	-8.29	7.63
1999	1.57	-8.25	9.82
1987	4.67	-0.74	5.41
1980	-1.34	-0.41	-0.93
1996	11.06	0.04	11.02
2003	27.22	1.32	25.90

[1]Represented by the Merrill Lynch U.S. High Yield Cash Pay Index except for 1980, which uses the Merrill Lynch U.S. High Yield 100 Index.
Bank of America Merrill Lynch Global Research (J0A0, H100, GA10).
Past performance is not indicative of future results.

Similarly, High Yield tends to generate attractive relative returns when the Fed is raising interest rates. The following compares High Yield returns to other fixed income asset class over the last three Fed cycles. Again, High Yield holds up very well in these periods.

Performance of Merrill Lynch Indices During Fed Tightening Cycles



Source: Bank of America Merrill Lynch Global Research, Bloomberg.
Past performance is not indicative of future results.

After a year like 2009, it is natural to wonder if High Yield has "run its course." Concerns over increasing interest rates may also be appropriate for fixed income in general. However, we maintain that High Yield valuations remain fair, particularly if the economy continues to expand. Additionally, rising interest rates should not impact High Yield in the same manner that they impact other fixed income securities. While we certainly do not expect a repeat of 2009, we think High Yield continues to provide attractive relative value.