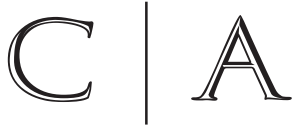

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

U.S. HIGH-YIELD BONDS: CHECK THE EXITS (SUMMARY)

August 2003

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U.S. High-Yield Bonds: Check the Exits

On the heels of the 6.2% return on high-yield bonds in November of 2002, we concluded that market conditions—above-average spread ratios, peaking default rates, and rising demand from yield-starved investors—were likely to extend the rally and deliver decent annual returns, but returns more like those of 1992-93 (upper teens) than those of 1991 (46%).[1] We were too cautious—as in 1991, investors have poured into the asset class in record volume, swiftly sending spreads and prices their separate ways. Over the nine-month period ended July 31, 2003, high-yield bonds returned 26.2% (36.4% annualized) and the ratio of their yields to ten-year Treasury yields narrowed from 3.54 to 2.02.

As a result, the easy money has been made and we would advise against initiating new allocations. However, for those with existing allocations, the more pressing question is, when to exit? The answer unfortunately is that it depends—on quality of the allocation, the skill of the manager, and the direction and progress of the economy. While high-yield bond returns have exceeded our expectations, a closer look reveals that much of the rally has been driven by an aggressive hunt for yield in credits of the lowest quality and least recourse (subordinated, C-rated bonds). As a consequence, Caa-rated bonds have become distinctly overvalued, while the Ba- and B-rated bonds (which constitute 80% of the total) are fairly valued-to-slightly overvalued.

Over the long term, the risk-adjusted performance of high-yield bonds has been directly and highly correlated to credit quality. For example, from July 1, 1983 through July 31, 2003, the Sharpe ratios of Ba-, B-, and Caa-rated credit tiers were 0.85, 0.43, and 0.01, respectively. The clear message is that high-yield bonds of the lowest quality should only serve as an opportunistic investment: investors should buy when the risk premium balloons, and sell when it reverts to the mean.

As of July 31, the ratio of yields on Caa-rated bonds to yields on ten-year Treasuries was 2.78, or just above the mean of 2.71 since 1987, while the ratios of Caa-rated bond yields to Ba- and B-rated bond yields were 1.76 and 1.35, or slightly below the historical averages of 1.78 and 1.43 since 1989 (See Tables B and C). However, on a spread basis, Caa-rated bond yields are over 200 basis points (bps) below their historical averages compared to Treasuries, Ba-, and B-rated bonds. Relative to ten-year Treasuries, Ba-rated bonds have credit spreads and ratios of 262 bps and 1.58 (close to mean levels), while B-rated bonds currently have credit spreads and ratios of 478 bps and 2.06, also near the averages of 558 bps and 1.90. Although Ba- and B-rated bonds are edging into overvalued territory, they appear to be more appropriately priced in light of their relative quality and stability. For example, the standard deviation of returns of Ba- and B-rated bonds is much lower than that of Ca-rated bonds (5.7% and 7.9% vs. 13.0%).

As with most opportunistic investments, however, it's easier to gauge when to pull the trigger in high yield than when to pull the plug. For example, many investors sold out of high yield in 1992 simply because it had delivered record returns in 1991. However, when the economy came roaring out of the recession in 1992 and 1993, high-yield default rates fell from 10.5% of issuers in 1991 to 4.9% in 1992, 3.5% in 1993, and 1.9% in 1994. Given that defaults were falling

[1] See our U.S. Market Comment, *U.S. High-Yield Bonds: Head Fake or Bull Market?*, (December 2002).

below their historical average, it made sense that spreads, which are predicated on default risk, should also fall below average (see Table D). As a result, high-yield bonds returned 17% in 1992 and 18% in 1993. Today, default rates (5.8%) and spreads appear to be in equilibrium, but investors should look for any *significant* breaks in this relationship—if defaults fall below average, spreads are likely to follow, but if defaults break trend and head higher, this may be a leading exit indicator.

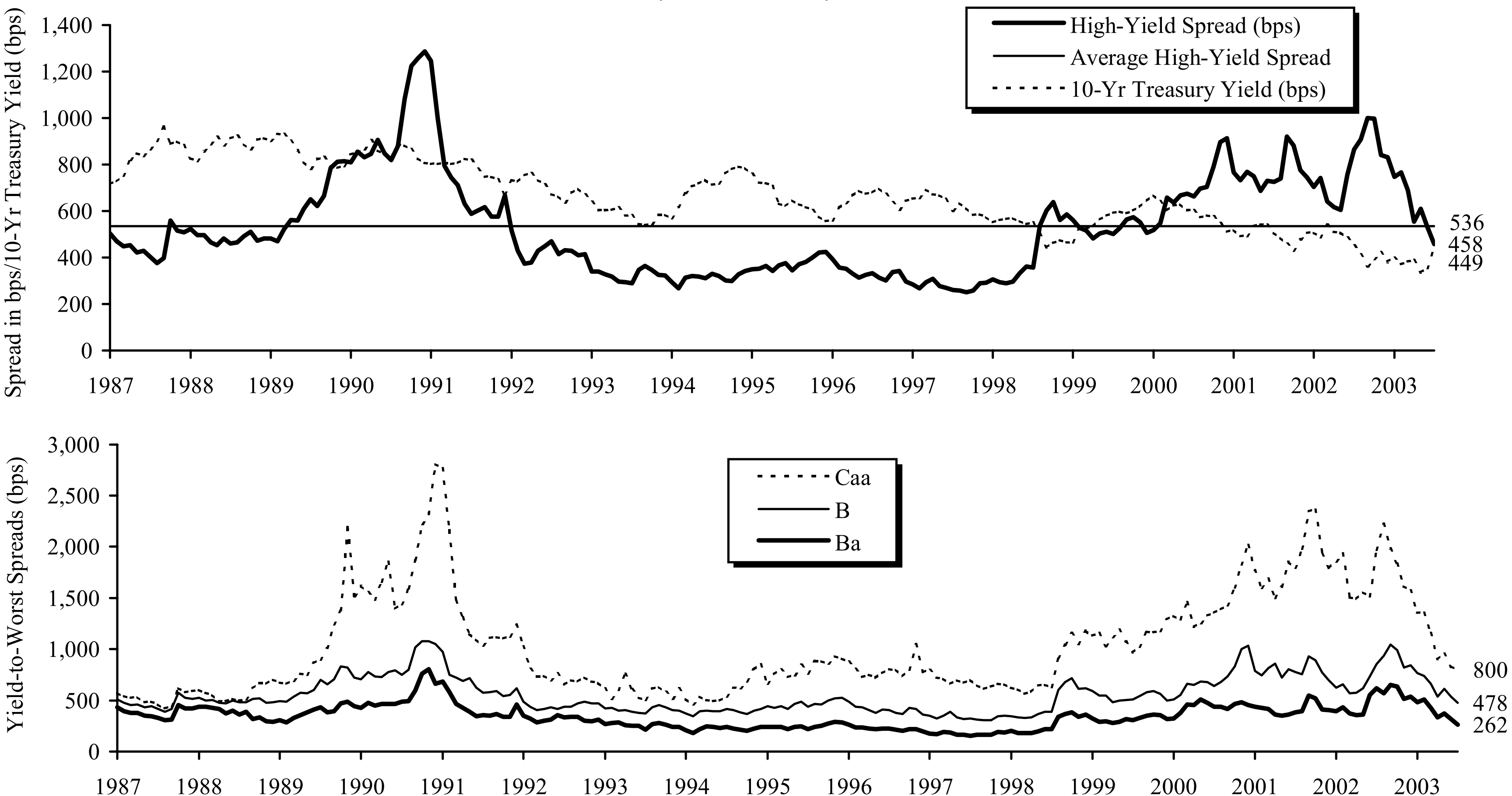
Another leading sell indicator can be a record level of new issuance that dwarfs the current supply of capital and weighs on existing prices. In the first half of 2003, 268 new issues came to market, more than the 251 new issues in all of 2002, but still below the 309 new issues in 2001. However, the increase in 2003 reflects a catch-up to the massive influx of capital into high-yield mutual funds this year ($18 billion through August 13, or 20% of beginning year assets) and pent-up demand from the credit crunch in the summer of 2002. More recently, supply and demand have been rapidly adjusting to each other. A net $2.6 billion left the high-yield sector in the week ended August 6, 2003, followed by an outflow of $1.1 billion in the week ended August 13, 2003. In short, supply and demand are quickly adjusting to maintain parity, but investors should remain on alert for a deluge of poor credits entering the market and/or a longer streak of significant outflows.

To summarize: we consider Caa-rated bonds overvalued and would recommend exiting allocations to this credit tier due to a lack of downside protection in a still fragile economy. However, even those with allocations to higher-quality credits should stand near the exits, sniffing for the smoke that may signal the next fire in this flammable asset class.

Table A

YIELD SPREADS OF THE LEHMAN BROTHERS HIGH-YIELD BOND INDEX RELATIVE TO TEN-YEAR TREASURIES

January 31, 1987 - July 31, 2003



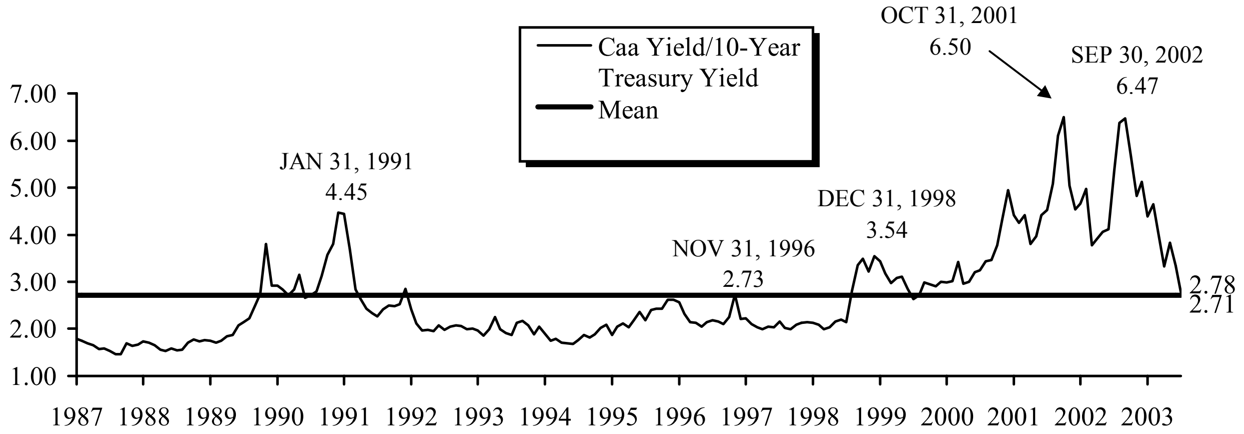
Sources: Lehman Brothers, Inc. and Thomson Datastream.

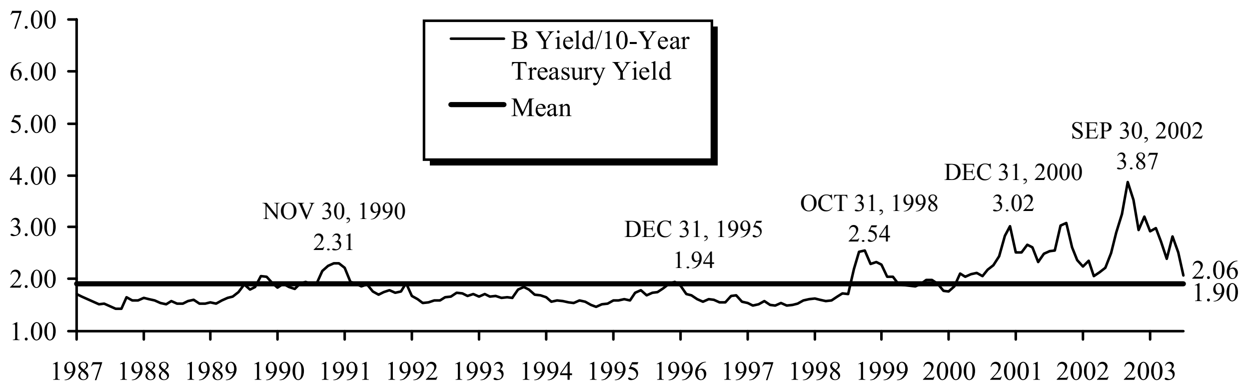
Note: Yield spreads are based on the difference between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for high-yield bonds and the yield-to-maturity for ten-year Treasury securities.

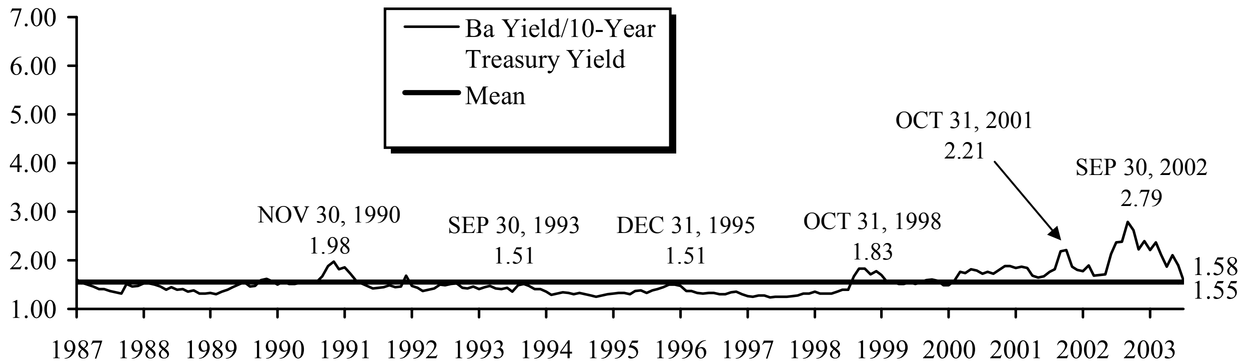
Table B

RATIO OF HIGH-YIELD BOND YIELDS TO YIELDS OF TEN-YEAR TREASURIES

January 31, 1987 - July 31, 2003







Sources: Lehman Brothers High-Yield Bond Department and Thomson Datastream.

Note: Yield ratios are based on the ratio between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for each high-yield rating category and the yield-to-maturity for ten-year Treasury securities.
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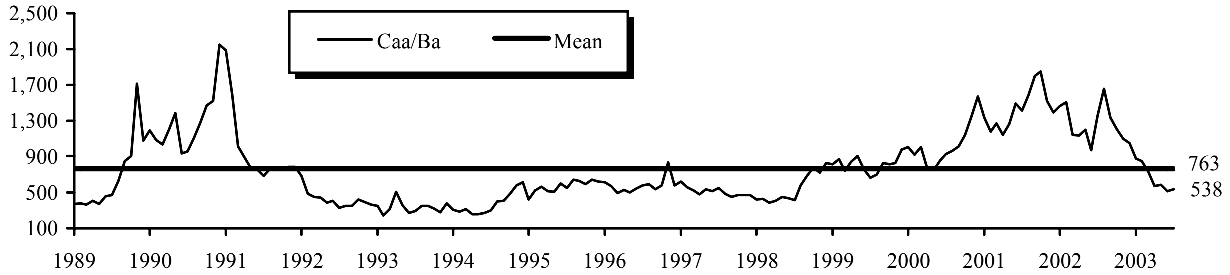
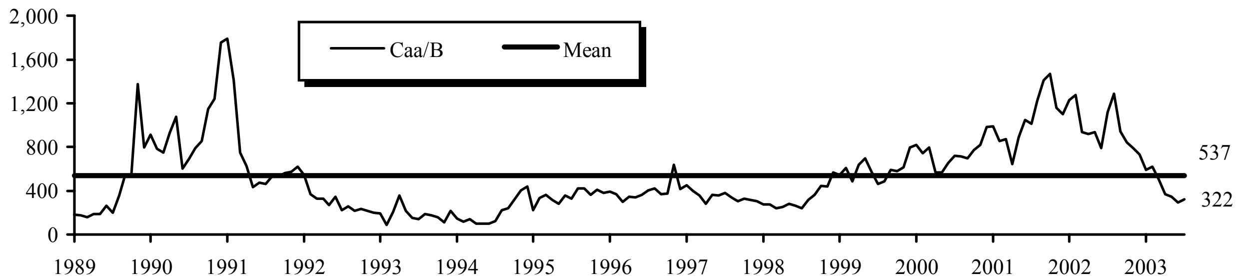
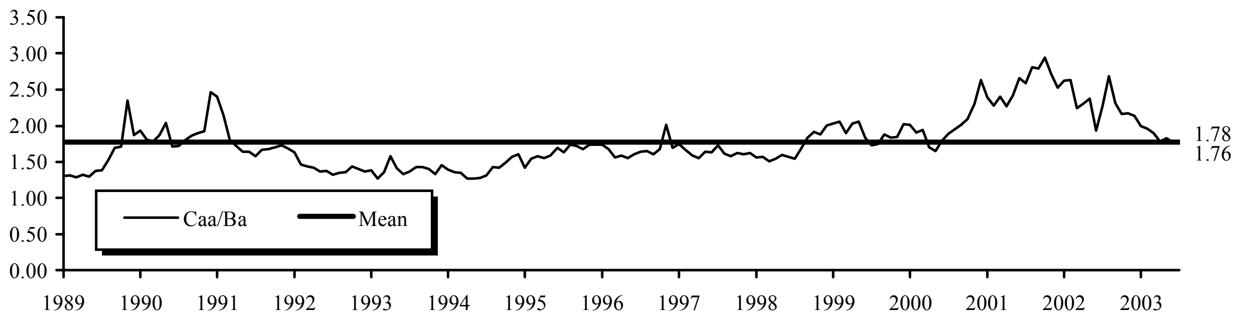
Table C

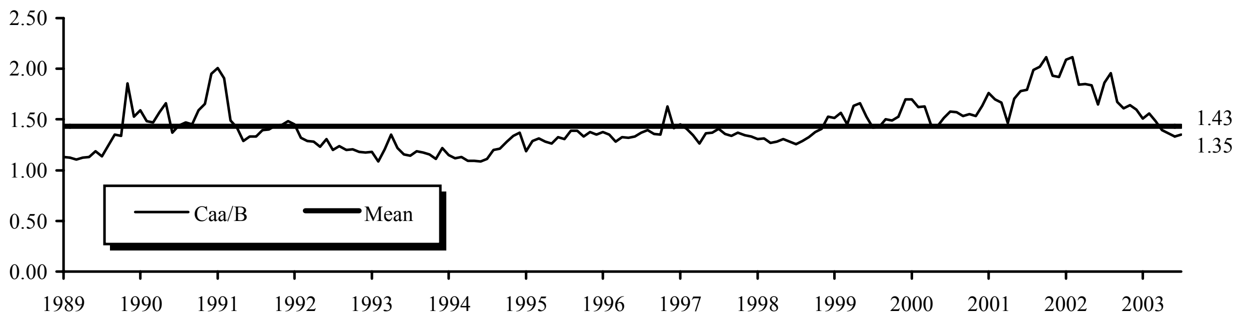
CREDIT SPREADS AND RATIOS AMONG HIGH-YIELD CREDIT TIERS

January 31, 1989 - July 31, 2003









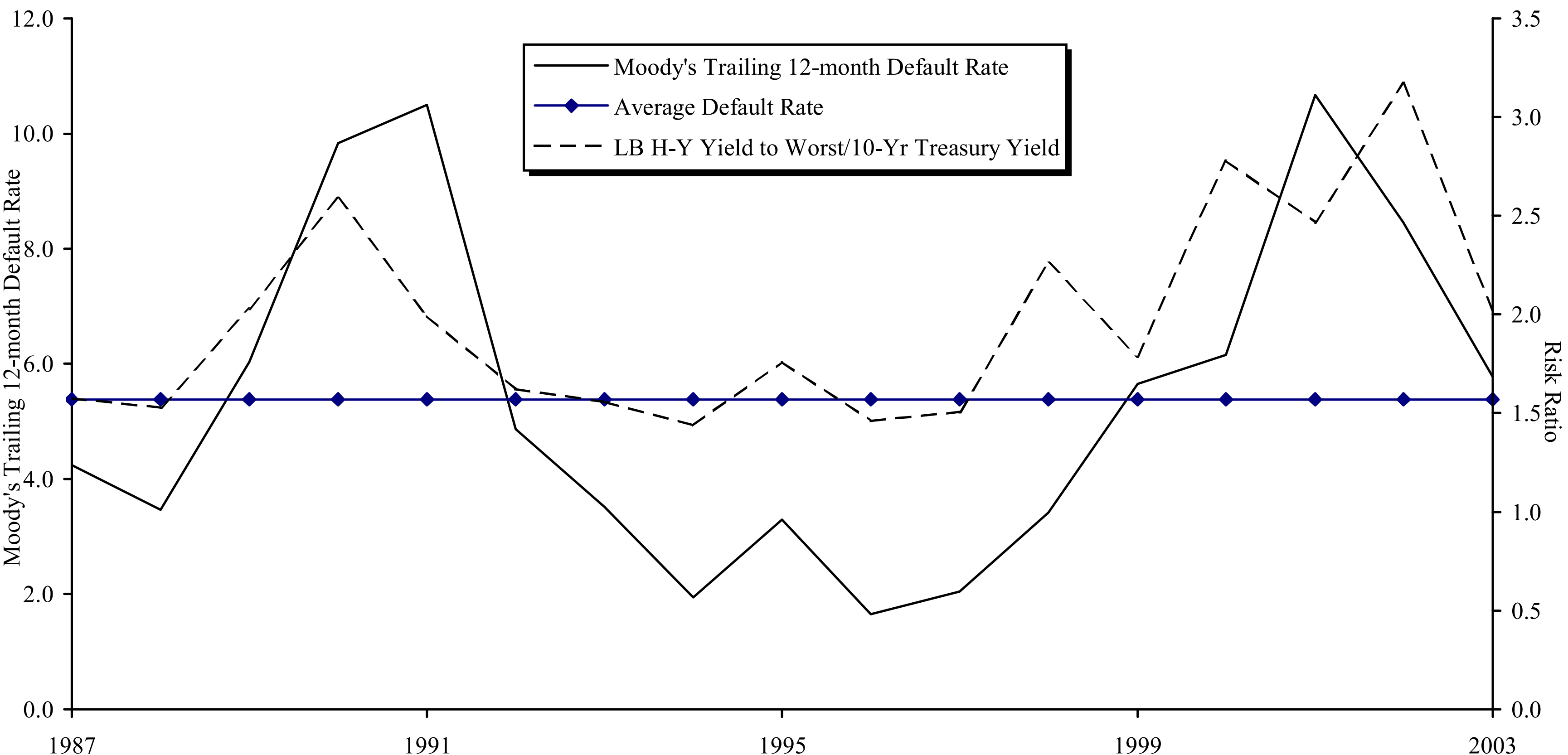
Source: Lehman Brothers, Inc.

Note: Yield ratios are based on the ratio between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for each rating category.

Table D

HIGH-YIELD DEFAULTS AND RELATIVE RISK

December 31, 1987 - July 31, 2003



Sources: Merrill Lynch & Company, Moody's Investors Services, and Thomson Datastream.

Notes: The Moody's trailing 12-month default rate represents the global percentage of issuers, where the United States represents 90% of the issuers. Historically, U.S. default rates have been lower than global default rates. In July 2003, the global default rate was 5.77%, whereas the U.S. default rate was 5.33%.