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Proceed with Caution

High-yield bond funds have hit some potholes recently, but don't consign them to the junk heap just yet.

By Susan Weiner

September 1, 2005- At first glance, high-yield bonds may seem to be at the end of a good run. At less than 2%, default rates are near historic lows, so you can't count on fewer defaults to boost total returns. Spreads between high-yield bonds and Treasuries are also near historic lows, roughly 4% as of early July, making it harder to justify the extra risk. Investors worry the market will be hurt by a significant slowdown in domestic growth and higher interest rates as the Federal Reserve tightens monetary policy. And in May, Standard and Poor's downgraded General Motors (GM) and Ford to below-investment-grade, raising concerns about the sector's ability to digest big batches of bonds from the automakers.

Back on Track

High-yield bond funds stumbled early this year, but a strong performance in June and July put them in the black, up 1.9% through July 31. They have also been strong performers over the past three years, returning 14% annually on average.

FUND	YTD Ret. (%)	1-Yr. Ret. (%)	3-Yr. Ret. (%)	5-Yr. Ret. (%)	Net Assets ($MM)
Fidelity Advisor High Inc Advant T	4.0	18.1	25.9	8.4	2,449.48
Fidelity Capital & Income	3.8	15.7	24.6	6.8	5,179.78
Loomis Sayles Instl High Income	4.3	18.6	24.4	10.2	100.44
Delaware Pooled High-Yield Bond	2.4	12.8	19.6	9.5	6.07
SunAmerica High Yield Bond A	4.7	17.2	18.7	7.4	343.25
MainStay High-Yield Corporate Bond B	1.6	10.7	18.3	7.1	4,488.14
Franklin AGE High Income A	2.8	12.1	18.2	7.6	2,960.45
Delaware High-Yield OpportunitiesA	2.5	11.6	18.0	7.3	127.13
Managers High Yield A	2.7	10.5	17.6	7.6	54.05
American Funds American Hi Inc Tr A	2.8	10.9	17.6	7.7	9,798.82
Nations High Yield Bond Prim A	0.6	9.7	17.1	9.5	1,020.21
Goldman Sachs High Yield A	2.5	11.5	16.5	8.0	2,051.11
Salomon Brothers Instl High-Yield Bd	2.0	10.4	16.4	9.5	167.99
Salomon Brothers High-Yield Bond A	3.0	12.0	16.3	8.3	2,291.42
WM High Yield A	3.0	12.5	16.1	8.3	797.28
John Hancock High-Yield B	1.1	11.2	15.9	7.2	854.55
Scudder High Income Plus Instl	2.9	12.1	15.8	7.5	383.41
Pimco High Yield Instl	3.5	11.7	15.7	7.7	6,921.25
BlackRock High Yield Bond Inv A	2.6	11.7	15.6	7.7	915.68
USAA High-Yield Opportunities	2.4	10.4	15.4	7.1	306.45

High-Yield Bond Average	1.9	9.7	14.0	5.7	

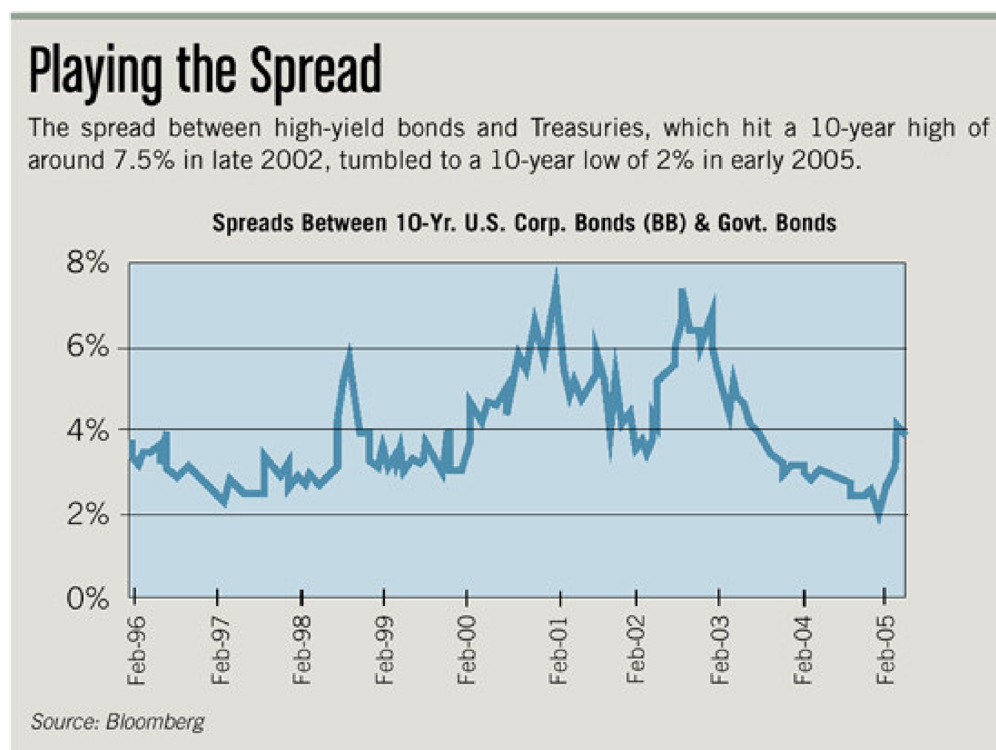
Note: Funds ranked by three-year returns as of July 31, 2005. Three- and five-year figures are average annual returns.
Source: Morningstar

So, can the outlook for high yield do anything but worsen? This is a more complex question than you might expect, given current market conditions.

NOT ALL GLOOM AND DOOM

First, with Treasury yields near historic lows as well, where else can you go for relatively attractive yields? And while default rates are low, they're only expected to rise to the high 2% or low 3% range by the end of 2005, says David Aniloff, an investment analyst on the global fixed-income team at SEI Investments in Oaks, Pa. Moreover, he adds, recovery rates from defaults have risen from 40 cents on the dollar to more than 50 cents.

In addition, the yield spread has actually climbed a bit since February, when it dipped to roughly 2%. (See "Playing the Spread," below.)



In any case, pricing, as expressed in terms of yield spreads, isn't the most important measure of the attractiveness of high-yield bonds, says Andrew Feltus, vice president and portfolio manager at Pioneer Investments in Boston. Rather, it's fundamentals, as long as the economy is strong. The economy may not be roaring right now, but neither is it stalling. Eric Takaha, senior vice president and portfolio manager for Franklin Advisers in San Mateo, Calif., says that economic growth in the range of 3% to 3.5% is adequate to make investing in high yield bonds worthwhile. And although short-term interest rates have ticked up, long-term rates, which junk bonds tend to follow, have moved lower or stabilized.

Finally, the markets seem to have weathered the downgrading of GM and Ford by at least one of the three major rating agencies (Fitch, Moody's and Standard & Poor's). Indeed, there could be advantages to having these downgraded firms, known as fallen angels, in the high-yield universe. "They are large, liquid names that let you express a view on the high-yield market," says Feltus, who manages the high-yield Pioneer Income Trust and the closed-end Global High Yield Fund.

"If you believe GM won't fail, at least in the next three to seven years, then the bonds are a buying opportunity," says George Padula, CFP and president of The

Danforth Associates in Wellesley, Mass. Bill Stafford, a co-portfolio manager of the Westcore Flexible Income Fund in Denver, likes GM and Ford so much, they're the two largest holdings in his fund.

Still, GM would account for about 13% of an unconstrained high-yield index, if lumped together with GMAC, Aniloff says. That's a bit much to swallow. Some managers are concerned that new fallen angels could whipsaw the benchmarks. To avoid this, SEI Investments switched its benchmark to the Merrill Lynch U.S. High Yield Master II Constrained Index, which limits positions to 2%.

This isn't yet a trend, however. Scott Berry, senior mutual fund analyst at Morningstar in Chicago, is aware of only one other fund making a similar move. The BlackRock High Yield Fund switched effective July 1, 2005, to the Lehman Brothers U.S. Corporate High Yield 2% Issuer Cap Index.

Defaults may eventually spike upward because quite a bit of low-quality high-yield debt was issued in late in 2003 and 2004. But the economy is healthy. It would take a recession to plunge high-yield bonds into disarray. These managers don't expect such a plunge.

They also point out that the high-yield sector is more diversified than in 2002, when telecommunication defaults roiled the market. Housing, energy, gaming and chemicals all have sizable weightings in the indexes, and they're all doing well, Aniloff says. Moreover, much of the debt has been issued to pay down debt rather than to engage in reckless expansion as during the telecom boom, Takaha says.

High-yield bonds do have a reputation for being risky because of their potential to default and their volatility. But they look more attractive when considered within the classic framework of diversification and asset allocation. "We view the risk of the asset class in the overall context of the portfolio," says Tom Orecchio of Greenbaum and Orecchio in Tappan, N.J. "Does it have the potential to reduce risk (measured in standard deviation) of the overall portfolio, even if some would view it as a risky asset class on its own?"

The answer is yes. High-yield bonds don't correlate exactly with either investment-grade bonds or stocks. Because their yields are higher than investment-grade bonds, they're less vulnerable to interest rate shifts, especially at lower levels of credit quality. And they're similar to stocks in relying on economic strength.

Still, before you invest in high yield, heed the old mantra about knowing your clients. They should be aware of the sector's risks in addition to its potential to provide attractive levels of income and to reduce overall portfolio volatility.

WHAT'S IN THERE?

Let's assume that you're ready to put your clients into high-yield funds. Do you know what you'll be getting?

You are making a big mistake if you assume that you'll invest only in bonds rated below investment grade. High-yield bonds are classically defined as debt obligations with a rating of Ba or BB or lower by Moody's or Standard & Poor's, respectively. They would be the main components of a plain-vanilla high-yield fund. But high-yield funds have greatly diversified. Some funds, like Westcore Flexible Income, avoid the high-yield bond label so they can range more widely. "Too many high-yield managers play in the box. That's where the majority of losses are," Stafford says.

Leveraged bank loans fall at the conservative end of the new additions. They are higher up in the corporate capital structure, so they're less likely to default. They are attractive now, according to Aniloff, because they are floating-rate loans based on LIBOR (London Interbank Offered Rate), so you don't give up much yield.

So-called "busted convertibles"--convertible bonds of companies whose stock price has declined so much that the conversion option isn't worth anything--have played a prominent role in some managers' portfolios. At Pioneer, the portfolio managers buy convertibles only at discounts so large that their yields are comparable to

below-investment-grade bonds, Feltus notes. "If their story works, their equity option has value and your total return is not capped." This results in "less downside and more upside," he says.

Some managers, like Stafford, go one step further and include some high-yielding common stocks in their portfolios. Preferred stock and warrants may also creep into high-yield funds. Another ingredient may be investment-grade bonds that are trading at discounts so their yields are high--the situation GM was in shortly before its downgrade.

Feltus takes a global approach to high-yield investing in hopes of winning higher yields and fewer defaults. The United States represents only 50% of global high-yield markets, so those investors who stay domestic are missing out on a broad range of opportunities, he says.

Emerging markets account for about 30% of global high-yield markets. They are cheaper than their U.S. peers because of the smaller market for them. "That's where you can find some of the best companies in the world, and you get paid a big yield premium," Feltus says. For example, there's Brazil's CVRD (Companhia Vale do Rio Doce), the world's largest producer of iron ore. "You get a yield of 7.5% for an A-type quality company," he notes. Combine U.S. high yield with its emerging market and European counterparts and you end up with "less volatility than traditional high yield has, but twice the returns," Feltus says.

He is less positive on credit default swaps (CDS), a derivative that's starting to appear in high-yield funds. "I won't make my money arbitraging versus cash," he says. "The Street pushes them since they are a higher profit margin business."

Stafford is concerned because the total value of the CDS market is greater than the value of the underlying bonds. If defaults became rampant, big problems would arise.

On the positive side, though, "CDS allow higher liquidity because there are no bonds that need to be delivered," Feltus says. Also, they allow portfolio managers to tailor duration, and they provide a relatively easy way to short the market.

If clients can tolerate more risk, advisers can also consider closed-end high-yield bond funds. Closed-end funds, unlike their open-end counterparts, can use leverage. "You get more juice because of the leverage," says Mark Briggs, an adviser in Glastonbury, Conn., who has used such funds in the past. However, leverage will also boost volatility.

Another alternative to open-end funds may be coming. Barclays Global Investors has filed with the SEC to create a high-yield bond exchange-traded fund as part of its iShares family. However, the pricing and the liquidity of the underlying holdings are a challenge that must be resolved before the new ETF comes to market, says Christine Hudacko, a principal with Barclays in New York.

Even with access to this broader range of investments, some advisers aren't as optimistic as the high-yield professionals about the future of this asset class. "We're at rock bottom for defaults. This has been played out," says Briggs, who has trimmed his clients' high-yield positions.

"I'm not comfortable with high yield," says Robert Matheson of Matheson Financial in Naples, Fla. With oil prices rising to more than $60 a barrel, he's concerned that the economy will crumple, taking high yield down with it.

PICKING THE RIGHT FUND

Let's assume you're ready to add high-yield bond exposure to your client portfolios. How do you choose a good manager?

"Picking a high-yield manager is much more difficult than choosing a typical investment fund, primarily because of the unknown risks of the underlying holdings," says Brad Stark, an adviser at Mission Wealth Management in Santa Barbara, Calif. For him, confidence in the fund management team is the top priority.

That squares with what fund managers recommend. "At the end of the day, the

high-yield arena is very much a security selection game," Takaha says. "You need to have analysts and managers who have been through cycles."

Size is a consideration at SEI, which is a manager of managers. The firm should be large enough to get market access, Aniloff says. Be careful if a firm has only a small retail high-yield fund, he warns, adding that a small retail fund complemented by a larger institutional high-yield business would be fine.

As for the fund, it shouldn't be so large that it has to hold a lot more names due to limited liquidity, Aniloff says. "The high-yield bond market isn't the most liquid area of the bond market, so the funds that experience big inflows will sometimes close to new investors. We see it as a shareholder-friendly move," Berry says. The analyst adds that there are only four closed high-yield bonds in Morningstar's universe right now.

Another factor is how much risk a fund takes. The fund's average credit quality is only one indicator. Default rate doesn't mean much because it's easily manipulated by managers who sell a security just before it's downgraded. Look instead at what has happened to the fund's total return during past downdrafts.

SEI divides high-yield managers into three major style categories that have some impact on risk. Core managers are very diversified and use bottom-up security selection. Opportunistic managers may throw in investment-grade bonds when spreads are wide enough, as well as bank loans, preferred stock and warrants. Value managers hold more concentrated portfolios and have significant tracking error versus the benchmark because they avoid big liquid names, Aniloff says.

Stafford favors low turnover as a sign that a fund is an investor rather than a trader. His fund's turnover for the past year was about 16%. "Many high-yield funds have astronomical turnover," he notes. They are hedge funds without the ability to short." He sees many funds with 100% to 200% turnover.

When it comes to high-yield bonds, there are a complex array of choices. Analyze them carefully to find the best match for your clients.

Susan Weiner, CFA, is a Newton, Mass.-based financial writer. She wrote about foreign bond funds in the July issue.

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