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Investing in Junk Bonds

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High yield bonds, or "junk bonds" as they are commonly called, are debt securities ranked below investment grade by the major credit rating agencies (S&P and Moody's). These bonds pay above-average interest because they carry an above-average risk that the issuer will default. The fate of high yield bonds is often tied to the issuing company's financial health and earnings, though some are tied directly to the company's assets. When the economy is growing and corporate profits and cash flows are relatively strong, high yield bonds typically perform well because the perceived risk of default is lower. However, when the economy slows, or worse, enters a recession, the risk of default increases and high yield bonds suffer.

A slow economy is tough on most companies and the rating agencies continually monitor corporate liquidity, asset levels, and cash flow to gauge the likelihood that individual bonds within a company's capital structure will be paid. As a company's fundamentals fluctuate, the rating agencies "upgrade" and "downgrade" individual bonds. Generally, as the overall economy slows, the expectation grows that there will be more corporate defaults in the marketplace and this causes the yields on corporate bonds to widen relative to U.S. Treasury bonds. Higher yields imply lower prices, and therefore, corporate bonds generally underperform U.S. Treasuries during economic slowdowns. The effect is magnified within the high yield market where yields can move from historical averages of 4.5% over Treasuries to 10%+ over Treasuries. In fact, high yield bonds hit an all-time historical wide yield spread over Treasuries in early October 2002 of about 11%. As the economy recovers, and the risk of default on high yield bonds decreases, spreads tend to "tighten" relative to Treasuries causing high yield bonds to outperform their government bond counterparts.

The last couple of years have been tough on the high yield bond sector. With falling interest rates, bond investors have favored U.S. Treasuries and high-grade corporates. The recession of 2001 and sluggish economy of 2002 had an obvious adverse impact on high yield bonds as well. As previously noted, the yield spread between high yield bonds and Treasuries recently reached all-time highs. We believe this increase in spread presents an opportunity. As the U.S. economy strengthens over the next several quarters (and we believe it will), high yield bonds will benefit. If the sector's yield spread relative to Treasuries were to tighten back to historical averages in a benign interest rate environment, investors would realize very significant capital appreciation in their high yield bond fund holdings.

One advantage to high yield bonds is that they are not highly correlated to either stocks or U.S. Treasury bonds. They are not as interest rate sensitive as treasury bonds (due to their high coupons) and are not quite as volatile as stocks. High yield bonds are a hybrid security that can help investors diversify their portfolio, offering potentially higher returns than Treasury bonds, but with typically less risk than stocks.

We like high yield bonds due to their combination of high current income, potential for capital appreciation, portfolio diversification, and lower sensitivity to the stock market. Depending on an investor's objectives and tolerance for risk, a 5% to 30% position in high yield bond funds, in an already well-diversified portfolio, is appropriate when we are in the recovery stage of an economic cycle.