MAINSTAY
CAPITAL
MANAGEMENT
LLC

The Value in High Yield Bonds
(12/31/08)

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 5% over Treasuries to 10%+ over Treasuries. In fact, due to the credit crisis and other extraordinary circumstances in 2008, junk bonds' yield spread over Treasuries grew to as high as 20 percentage points. 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 concern over the credit crisis, bond investors have favored the safety of U.S. Treasuries over corporate bonds, and especially over high yield bonds. The recession that started in December 2007 has had an obvious adverse impact on high yield bonds. In 2008, the high yield sector of the bond market declined about 27%, by far the worst showing in more than 20 years. As a result, the yield spread between high yield bonds and Treasuries recently reached all-time highs. We believe this huge yield spread presents an opportunity. As the U.S. economy eventually starts to recover, high yield bonds will benefit. The expectation that default rates will decline in a recovering economy will cause the sector's yield spread relative to Treasuries to tighten. This will in turn produce significant capital appreciation for the holders of high yield bonds. This combined with the current high yield of these bonds will result in significant total returns.

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 somewhat unique security in that they 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 during economic recoveries 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 25% position in high yield bonds, in an already well-diversified portfolio, is appropriate when we are in the recovery stage of an economic cycle.

For an aggressive, pure play in high yield bonds, **Fidelity Capital & Income** (FAGIX) has a good historical track record. In fact, the last time yield spreads reached an all-time high of about 11% in late 2002, Fidelity Capital & Income returned 40% to investors in 2003. Other picks in this sector available in many 401(k) plans include **T. Rowe Price High Yield** (TRHYX), **Dreyfus Ltd-Term High Yield** (DPLTX), and **Shenkman Capital High Yield Strategy**. There are also plenty of ETFs in this sector like **iShares iBoxx High Yield** (HYG), **SPDR Lehman High Yield** (JNK), and **PowersShares** High Yield (PHB).

Finally, since high yield bonds pay out a large portion of their total returns in interest payments, which are taxable income, high yield bond funds are best placed in tax-deferred accounts, such as IRAs and 401(k)s.