

U.S. HIGH YIELD / FEBRUARY 2010

## U.S. High Yield: Still a Choice for These Times

A recent survey of Chief Investment Officers<sup>1</sup> showed that many expect fixed-income investments, particularly high-yield and investment-grade corporate bonds, to be leading performers over the next year. Given the sector price performance in 2009, this prognosis may appear naïve to many investors. While high-yield securities have been written back up to at least fair value, to us the absolute current yield and total return prospects remain very attractive in today's low interest rate environment.

Going into 2009, the major risk for the high-yield sector was the fear of voluminous defaults brought on by an inability to refinance or gain liquidity due to the banking crisis. Many credits, especially a number of recent large leveraged buyouts, were vulnerable. In January 2009, Moody's default model estimated that the issuer default rate would top 15% by year end.<sup>2</sup> The model by Standard & Poor's gave even higher possible default ranges if markets deteriorated further. However, in 2009 many of the near-term refinancing and liquidity issues were resolved by new capital flows into the high-yield sector, as investors regained confidence and sought higher yields. We now believe high-yield default rates have peaked and are not likely to materially disrupt market activity. We expect default rates to decline over the next year into the 4% to 6% range. Defaults may create an underlying drag on the market, but will probably only affect the most vulnerable lower tiers.

High-yield and corporate credit fundamentals appear to be improving. Many credits completed substantial refinancing in 2009, which enhanced their liquidity and modestly repaired their balance sheets. Some even managed to sell equity to reduce debt. Additionally, corporations cut costs and reduced inventories to right size their businesses. Over the first few quarters of 2010, U.S. Government fiscal and monetary stimulus should continue to positively affect the economy, bolstering the prospects for top-line growth and further corporate recovery. As a sign of improvement, over the last several months rating agency upgrades of corporate credits have outpaced downgrades for the first time in several years.<sup>3</sup>

Interest rate risk is always a concern when investing in bonds. With the weak U.S. dollar and substantial financing requirements, rising U.S. Treasury interest rates are probable. High-yield and corporate securities generally outperform in a rising interest rate environment, as their larger coupon cushions their price erosion relative to the price change in U.S. Treasury securities. Current credit spreads are not inordinately tight—the Merrill Lynch U.S. High Yield Cash Pay Index spread is 628 basis points as compared to its long-term average of 574.<sup>4</sup> The CCC Index sector credit spread is now narrower than its long-term average, while the BB Index sector spread is modestly wider than its long-term average.

In consideration of the above factors, we are more constructive and positive on the market today than we have been in several years. We believe 2010 will be a year of high single-digit returns for the U.S. high-yield market, and that such returns will represent very good value for investors. While tactical investors in the broad high-yield market may have captured strong returns in 2009, we continue to favor a strategic allocation to better-quality high yield.<sup>5</sup> The better-quality high-yield sector has produced the best long-term risk adjusted returns within the high-yield sector, as illustrated in Exhibit 1. Finally, we believe a strategic allocation to better-quality high-yield is apt to provide better long-term stability and predictability of portfolio returns—hopefully an important goal of investors.

*Written by Bill Charlton, Director, U.S. High Yield*

## Exhibit 1: Comparative Index Performance

Returns, Standard Deviations, and Sharpe Ratios\*

	1/1/1989 - 12/31/2009		
	<u>Annualized Return</u>	<u>Standard Deviation</u>	<u>Sharpe Ratio</u>
<b>Merrill Lynch U.S. High Yield Cash Pay Index</b>	8.54	8.52	0.49
<b>BB</b>	8.71	6.93	0.63
<b>B</b>	8.11	8.89	0.42
<b>CCC</b>	7.89	14.10	0.25
<b>Barclays Capital U.S. Aggregate Bond Index</b>	7.36	3.92	0.77
<b>S&amp;P 500 Index</b>	9.40	14.95	0.34
<b>NASDAQ</b>	8.83	23.60	0.19

As of December 31, 2009

\*Source: Merrill Lynch U.S. High Yield Cash Pay Index and Cash Pay BB, B, CCC sub-indices, Bloomberg, Lazard Asset Management. Performance represents past performance. Past performance is not a reliable indicator of future results.

### NOTES:

1. Source: Morgan Stanley Investment Management's inaugural Institutional CIO Confidence Index. Survey conducted over a six-week period ended November 1, 2009.
2. Source: Moody's. As of January 14, 2009.
3. Source: Bank of America-Merrill Lynch Monthly High Yield Market Review. As of January 4, 2010.
4. Source: Bloomberg and Merrill Lynch. As of December 31, 2009.
5. The Lazard U.S. High Yield team defines better-quality high-yield as securities with a rating of B+ or higher. Generally, the team uses the Merrill Lynch BB Cash Pay Index as a proxy for a better-quality index.

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An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

The Merrill Lynch U.S. High Yield Cash Pay Index is constructed to mirror the public high-yield corporate debt market and is a subset of the Merrill Lynch High Yield Master II Index. The Index is unmanaged and has no fees. One cannot invest directly in an index.

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