

FIXED INCOME / AUGUST 2009

The Opportunities Offered by Dispersion

The past year has been an incredibly interesting time in fixed income markets, and some of the changes we have seen are likely to impact investors for many years to come. Over the past decade, low interest rates, high amounts of leverage, and considerable liquidity increasingly allowed for a situation where fixed income securities traded as if there was a “virtual” exchange. Investment banks maintained high bond inventory and investors increasingly looked at bonds in much the same way as they looked at stocks. In many circles, there was a perception that fixed income securities were homogenous and fungible. Also, as economic conditions were relatively friendly in the era of disinflation, many investors significantly discounted risk in an effort to purchase yield, ignoring the fact that risk and yield remain two sides of the same coin.

Without rehashing the details of the market collapse in 2008, the scenario described above is an important backdrop as we look ahead to the second half of 2009 and beyond. There appear to be some important changes in the way fixed-income markets are working and, assuming we do not have a quick reversal back to cheap financing and high degrees of leverage, it would seem that these changes are long-lasting. Based on these circumstances, we believe that many of the mathematically driven models of the past could be permanently broken, and that excess returns in fixed income may be achieved by those investors that conduct fundamental security analysis as a basis for understanding investment risk.

The movement of the market back to an over-the-counter environment is significant, as bonds are less liquid, more difficult to locate, and generally have higher transaction costs. This environment has also encouraged a lot of new issuance, as corporations are providing supply for the high demand of those looking to gain credit exposure. This is relevant going forward, as credit spreads are now tighter than they were prior to the Lehman Brothers bankruptcy, and we do not believe that market conditions are more benign today than they were a year ago. In fact, many parts of the credit market remain somewhat frozen or illiquid, and a lack of true debtor-in-possession financing, or private equity turnaround capital, could lead to a higher than normal amount of defaults, as companies may lack the ability to move into Chapter 11 Bankruptcy to reorganize. The difficulties recently encountered by Circuit City and CIT help to illustrate this point. As we are likely moving towards a significant downgrade cycle, we are concerned about corporate credit risk, particularly in the U.S. markets and particularly in the higher-risk, lower-rated securities.

DISPERSION OF RETURNS

Another factor that we believe investors need to be aware of going forward is how to gauge performance. It has been common to discuss the broad market indices, such as the Barclays Aggregate or the Barclays Global Aggregate Indices, and use those as a proxy for overall market performance. However, we have seen, and believe we will continue to see, high dispersion across the different sectors of fixed income, as well as dispersion within these sectors. Several examples will help to illustrate this.

U.S. Aggregate Market

While the U.S. Treasury market was down 3.02% during the second quarter of 2009, the overall bond market turned in a positive total return of 1.78% as a result of the dramatic revaluation of high-risk investment grade assets. As examples, for the quarter BBB-rated securities were up 30.28%, and investment-grade ABS securities rated less than AAA were up 27.21%.¹ The positive 480 basis point difference between the aggregate market’s total return and the Treasury market’s total return was the highest quarterly difference in the published history of the indices, which dates back over 30 years. We do not believe the current market conditions are sustainable and, in general, are very leery of corporate credit exposure in the United States.

U.S. Corporate Market

With so much recent attention on corporate credit, it is interesting to note how the sub-components of the Merrill Lynch U.S. Corporates, A Rated Index are behaving. Prior to mid-2007, there was very little dispersion among the different sectors. Since then, the sectors have diverged to the point where the average is somewhat meaningless. While the Index implied a 5.5% yield as of June 30, 2009, an investor looking for this exposure would have a difficult time accessing it. On average, industrials ex-telecom yielded 4.5%, gas & electrics yielded 4.9%, and financials 6.5%.² Our view is that the higher-quality securities have all come in too far, that the narrow spreads on high-grade corporate paper are generally not worth the risk, and that there is still much uncertainty regarding many of the financials. While investors are paid a premium to own financials in the A-rated space, we question whether this premium is enough to compensate for the risk. Based on this type of analysis, we continue to believe that ample opportunity exists for a U.S. core manager to achieve top-quartile returns by focusing on security selection in structured products, particularly within Agency MBS, and trying to limit credit risk.

U.S. High Yield Market

Within the U.S. high yield market, the demand for credit has been high and the supply of quality securities has been limited. Therefore, in order to get market exposure, investors that have come into this space in 2009 have been likely forced to own riskier tranches of credit. To this point, as risk appetite returned to the market, CCC securities posted a 40% return in the second quarter, as compared to the 15% return of BB securities.³ We do not believe this is sustainable, particularly as unemployment numbers continue to rise and growth expectations for the economy are pushed out further into 2010. If we continue to see the default rate rise to market expectations, we feel it is reasonable to assume that the riskier credits will be far more susceptible to default than the higher-quality issues, which we believe have a better opportunity to survive.

Global Markets

We also see a large amount of dispersion in global markets, where we think there is ample opportunity to be selective in even the most attractive sectors. While we believe it is important to be diversified, it is also important to be correctly diversified. While emerging markets have overall been a fairly attractive space, we believe the best way to add value is to participate selectively in those nations where financial conditions seem to be the healthiest in terms of trade balance, budget deficits, and other factors. We believe that it is not good enough to have broad emerging markets exposure, but it is important to have the correct exposure, as different countries will likely proceed on different paths based on financial strength.

FINDING OPPORTUNITY

We believe that that policy action in the United States and across the globe seems to have largely eliminated the tail risk of a global depression. With that risk largely out of the way, the main uncertainty for global markets lies in the timing and shape of the global recovery. In making country investment decisions, it is important to carefully filter and compare fiscal conditions, sovereign balance sheets, and policy framework. Countries that continue to move forward with pro-growth fiscal policies would appear better positioned than those where government is looking to take tighter control. To this point, we believe that many countries outside of the United States may recover faster, especially select emerging markets and commodity-based countries. We are especially optimistic about select Asian and Latin American countries, which have exhibited impressive economic and financial resilience during the recent crisis. External vulnerability in many countries has also diminished, thanks to stronger trade balances, a renewed risk appetite, and International Monetary Fund liquidity.

Going forward, it will be important for investors to truly understand the exposures they want to take, and then figure out the most effective way to implement those decisions. The ability to separate out the winners from the broader market will likely be a significant source of excess return for the time being. This puts the onus on managers to be forward-looking and active in their investment approach. In the U.S. markets, this point is highlighted by the vast opportunity we see in structured product. By digging deep and understanding how specific pools of loans may act under different scenarios, we believe it is possible to extract value, as many of these non-homogenous securities are priced similarly despite having very distinctive characteristics that will likely lead to different streams of future cash flows.

NOTES:

1 Source: Barclays

2 Source: Merrill Lynch

3 Source: Merrill Lynch

Published on 6 August 2009.

Past performance is not a reliable indicator of future results.

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. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

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