

Over the last several months, deteriorating economic conditions have lured investors away from riskier assets and into safer havens such as treasuries and money markets. Since the summer of 2008, spreads for high-yield bonds over treasuries have measurably widened, reaching 16 percentage points last week. With effective yields nearing 10%, the question arising is whether we are near a tipping point to jump into these high yielding instruments or will fears over future economic uncertainties prove too high for investors to make a risk commitment of this magnitude?

A Bond History Lesson

For generations the American bond market has been dominated by two large bond rating agencies, Moody's and Standard & Poor's. The agencies rate a corporation's risk factors in order to help guide investors on Wall Street. Companies trying to attract investors are given a rating and are divided into two categories—either investment grade or below-investment grade bonds.

A "AAA" rating is given to top blue-chip corporations. These bonds usually yield very low interest rates to investors. BBB is the lowest credit rating considered to be a worthy investment grade. Below BBB are the speculative or high-yield bonds Wall Street called "junk bonds," because their companies had fallen on hard economic times. These bonds pay high interest and are sold at a discount because of their high risk factor. Junk bonds raised billions of dollars for companies such as Texas Instruments, MCI, CNN, and many other household names in the 1980s. And then the world of junk bonds came crumbling down.

In 1990, the king of junk bonds, Michael Milken, pleaded guilty to six counts of securities fraud and conspiracy, paying \$600 million in fines and spending 22 months behind bars. Immediately after Mr. Milken was exposed, junk bonds decreased rapidly but later rebounded and had the best year in their history, returning 46% in 1991.¹

Where Are We Headed? Is Now a Good Time For Bonds?



The determining factor for bonds could be the view of default rates over the coming year. While some expect them to increase dramatically, defaults are currently well below their historical average. The expected default rate of 8.5 percent for 2009 is a similar indication to past recessions over the last twenty years. The default rate during the 2001-2002 recession averaged 7.3 percent to 8.3 percent and the rate during the 1990-1991 recession averaged 8.7 percent to 10.5 percent. It would seem that the default rate is where it should be, and based on past recessions, should not get much higher (it is currently four times the 2007 level of 2.3%).

Investors have poured out of equities since late 2008, indiscriminately selling anything and everything they could get their hands on. The swift movement from equities to less risky investments such as treasuries and money-markets excluded the high-yield market as investors flocked to a safer haven. This differs from many past flights to and from quality, which have seen the high-yield market serve as a stepping stone for investors' risk appetite as they shift along the spectrum between higher-risk equities and lower-risk corporate bonds. We believe that investors will test their hand at the high-yield market before we see a major movement back into equity markets.

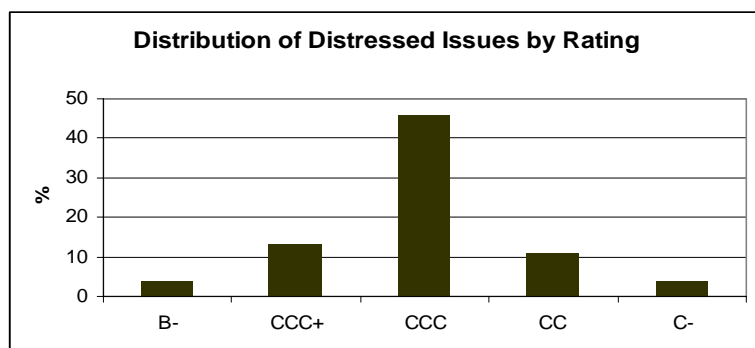
Many experts believe that the best signal for a new bull market is a tightening of the credit spreads between high yield debt and treasuries. As the chart to the left shows, an influx into the high yield bond and distressed debt market has begun to have an effect—spreads have tightened by 4%.

¹ Return based on the Lehman High Yield Index.

If this is the bottom, why not go all in to Equities?

Stocks are appealing at their current levels, but the road to higher prices could be bumpy, and stocks are, of course, more volatile than high-quality bonds. But if you're nearing or are already in retirement, you should have 40% to 50% of your money in bonds. With the current market environment, bonds are priced low and offer the potential for fine returns over the next year or so.

At their lows in late November and early December, bonds were discounted to depression rates. If the future brings anything rosier than that, their prices, which have already started rising from earlier lows, should appreciate further. Many analysts forecast that investment-grade corporate bonds could easily return 10% or more this year. Of course, we cannot predict what the markets will do, or what bonds will *actually* do.



But yield is hardly the whole story. The prices of corporate bonds have been beaten down as a result of the credit crunch and concerns about the health of the economy. The differences in yields between Treasuries and most other bonds are higher than they have been since the 1930s.

More than 70% of the junk market is trading at distressed levels— meaning that they are offering yields at least 10 percentage points higher than Treasuries. The average junk bond yields about 17 points over Treasuries.

Our Fixed Income Model

Within the fixed income portion of our portfolios, we are currently working to implement a new model of 60% core bond holdings and 40% satellite holdings. To obtain this, the core holdings will closely resemble the Lehman Aggregate Bond Index, which is currently yielding 4-5% and is comprised of higher-quality bonds. Within the satellite portion of the fixed income portfolios, we look to invest in distressed, higher-yielding instruments that have current yields ranging between 9-15%.

We began taking this approach with our fixed income holdings late last year and will continue to make purchases in bonds until our portfolios have reached an optimal risk/reward balance. Please note that there is no guarantee that our fixed income investments will achieve the same yields as set forth in the model.

About Risk

Past performance is no guarantee of future results. This article contains forward looking statements and projections. There are no guarantees that these results will be achieved.

- Fixed Income investments are subject to various risks including changes in interest rates, credit quality, inflation risk, market valuations, prepayments, corporate events, tax ramifications and other factors.
- Investors should understand the relationship between bonds and interest rates. If interest rates rise the value of bonds will subsequently fall. The effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.
- Investors should note that rebalancing a portfolio may be a taxable event. Additionally, an investor may incur fees or charges as a result of rebalancing certain investments held within their portfolio.
- The Lehman Brothers Aggregate Bond Index is an unmanaged index considered representative of U.S. fixed-income securities. The Lehman Brothers High Yield Index is an unmanaged index considered representative of U.S. high-yield bonds.
- An investment cannot be made directly in an index.
- Investing in lower quality debt securities, commonly known as “junk bonds”, involves greater risk of default or price changes due to changes in credit quality of the issues because they are generally unsecured and may be subordinated to other creditors’ claims. Credit ratings on junk bonds may not reflect their actual market risk.

Material discussed herewith is meant for general illustration and/or informational purposes only. Please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice. Views expressed may not reflect the views of FSC Securities Corporation.

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