

# HIGH YIELD IS NOW THE RIGHT TIME?

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From a technical perspective the high yield market is still in a state of flux. However, from a fundamental perspective, we believe that the high yield market offers attractive value in the current economic environment.

The high yield market experienced a 537 basis point widening in risk premium, as measured by the change in spread-to-worst from 257 basis points on May 23, 2007, to 794 basis points on February 29, 2008. The slide began in June 2007 and persisted through February 2008. In that span, the total return for the asset class was -5.31%. This slide started with the subprime mortgage issues and moved through issues surrounding the hung LBO bridge calendar, monoline insurer viability issues, general concerns about the health of the U.S. and European banking systems, technical weakness in the U.S. leveraged loan market, asset backed market problems, and overall economic concerns.

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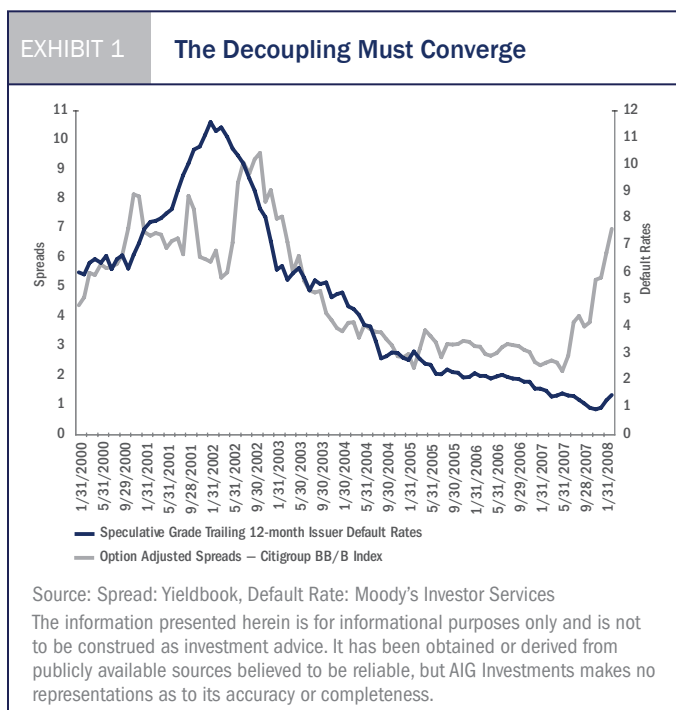
Operating fundamentals across the bulk of the high yield subsectors are still at acceptable levels. High yield spreads are approximately 300-350 basis points wide of their long-term historical averages while default rates are 250-300 basis points inside of their long-term historical averages, all driven by weak technicals. This is the classic “more sellers than buyers” scenario that typically drives prices low enough to attract new buyers.

The lower high yield default rates are likely to rise to approximately 200-250 basis points during 2008 from less than 100 basis points during 2007; a level well below the historical average.

Default rates are likely to increase in 2009, but we do not believe that the default rate will reach the 1000+ basis point level implied by the Garman Model as of January 2008.<sup>1</sup> This is due to the structural change in the high yield market associated with the composition of the largest issuers, relative to the last downturn in the early part of the decade.

The issue for the near-term high yield market is technical: investors fear further degradation of other, higher-rated, asset classes, which is keeping them out of the high yield market. While certain high yield credits offer compelling value in today’s market, the market will likely not rally until many of the following happen:

- LIBOR stabilizes, providing a bottom for leveraged loan pricing
- Large investment banks dispose of their hung 2007 leveraged buyout (“LBO”) financing commitments



<sup>1</sup> Garman Model as supplied by Merrill Lynch.

- Monoline insurers resolve their rating and structural issues
- U.S. and European banks and other financial institutions provide clarity to the investment community regarding the value of their assets and the amount of their contingent liabilities
- The U.S. economy resolves its possibly recessionary status
- Countrywide Financial and Rescap deal with their second quarter debt maturities.

Investors with cash and patience will be able to capitalize on the current environment. We believe there are compelling values in the high yield market at the moment, but investors need to ride out the volatility associated with problems outside of the high yield asset class.

High yield investors cannot control when, or if, bond insurers MBIA and AMBAC will be downgraded; when the next financial institution will take an unexpected write-down; or which hedge fund will close its doors, liquidate certain funds or restrict investor redemptions like Sailfish, D.B. Swirn and Citigroup have done recently. High yield investors with a longer-term perspective can take this opportunity to build a portfolio at attractive prices that should perform well over time.

## Liquidity

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So far in 2008, liquidity in the high yield market has been poor. This is evidenced by:

- New issue volume, which is down
- Wider average bid-ask spreads in secondary trading

To date in 2008, new issuance has totaled only \$7.9 billion in eight deals. At this point last year, however, the market had priced US \$23.4 billion in 77 deals. Unfortunately, there is little evidence that market activity will pick up in the near term, due to the hung LBO deals on bank balance sheets. Secondary trading, however, has begun to recover from exceptionally poor conditions at the start of this year. In highly liquid markets the average bid-ask spread can be as low as ½ of a bond point.

At the beginning of 2008, the average was somewhere between 2-4 points reflecting the tremendous stress in the market at that time. Currently, however, the average lies closer to 1 ½ points as dealers seem more willing to commit small amounts of capital to the market. Until the investment banking community is able to repair its own balance sheets, its ability to commit capital to the market, thus improving liquidity, remains constrained. This has and will generate price volatility in both upward and downward periods this year.

## Technical Issues

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The single largest technical issue surrounding the high yield market is the 2007-vintage high leveraged buyout calendar. Currently, banks are sitting on approximately US \$150 billion of leverage loan and \$70 billion of high yield bond commitments associated with leveraged buyouts (LBO) from the first half 2007.

These LBOs were the result of significant private equity raises and accommodative debt markets. As such, LBO sponsors overpaid for many of these deals and the debt financing commitments do not have market prices, structures or covenants. These debt financings are not likely to be sold into the leverage loan and high yield markets and thus the banks are saddled with significant capital commitments. The banks have become investors rather than distributors.

Until the banks solve the hung LBO issue the high yield calendar will be small. Thus, organic senior subordinated high yield supply will not overwhelm the market. We expect some senior secured note supply to come from 2003-2005 vintage leverage loans that begin to mature this year, with limited ability to refinance in the leveraged loan market, due to the inability to issue new collateralized loan obligation ("CLO") funds. However, this market will take some time to develop and we do not expect large high yield issuance in the near-term.

## 2008/2009 Total Return Potential

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We have a wide expected return range for high yield in 2008. The reason for this is uncertainty surrounding general economic conditions in the United States. However, given the level of yield spreads available in the market and the relatively benign default rate, the market has the potential to have a good rest of 2008 and 2009. The following table highlights several return scenarios based on spread movement. Our most

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March 4, 2008 Spread to Worst <sup>3</sup>	Spread Action	12-Month Total Return Potential
795	-200 bps	18.29%
795	-100 bps	13.68%
795	0 bps	9.07%
795	+100 bps	4.46%
795	+200 bps	(0.15%)

<sup>2</sup> There can be no assurance that the targeted return will be met, or met over any particular time horizon. If one or more of the assumptions used in the formulation of the targeted return turns out to be incorrect, the target may not be achieved. Targeted returns do not take into account unanticipated material changes in the market and/or other economic conditions affecting the investments, transaction costs that may arise, the imposition of taxes and the actual sale or trade of investments. As a result, there can be no assurance that the investment manager took into account all relevant variances affecting these results or that the assumptions are accurate in light of actual changes in the market and/or economic conditions affecting the investments. Targeted returns should not be relied upon. Targeted returns are calculated gross of management and incentive fees. Had such fees been taken into account, the results would be lower.

<sup>3</sup> Source: Lehman Brothers, based on the Lehman Brothers U.S. Corporate High Yield Index

probable scenario is that spreads end 2008 100 basis points around their starting level implying a total return range of 4.46-13.68%.

Thus, at current spread levels high yield investors are being paid sufficient yield spread to minimize price downside relative to recent historical wides. If yield spreads do not change, investors will still be rewarded with more than 9% returns from coupons.

## Outlook

We believe that many high yield issues offer compelling value in the current market. However, until the aforementioned technical factors abate, it is unlikely that we will see a sustainable rally across the asset class.

Through February 29, 2008, the Lehman U.S. Corporate High Yield Index has posted a -2.68% total return as investors shed risk. Based on our estimates of an average 3.5% default rate over the next two years, 40% recoveries on high yield defaults and a 450 basis point long-term average high yield spread, we think fair value is likely around 500-600 basis points over Treasuries for the asset class in the current economic environment. This implies approximately 200-300 basis points of potential spread tightening in the market when the non-high yield issues resolve themselves.

To the extent that the economy has serious longer term issues this spread tightening will be delayed, but at this point our credit research indicates that most companies do not expect a serious, longer downturn. In addition, certain Street strategists indicate that at current levels high yield investors can expect attractive returns over medium periods of time.

As a result, our best case assumption is that the market could post a 12-month total return of as much as 18.29% if the technicals resolve themselves and we move to the tight end of fair value to as low as (0.15%) if the market remains weak and reaches the wides of the last downturn. Our base case 12-month return range is more moderate at 4.46-13.68%.

All things considered, the fundamental backdrop in the market makes a strong case that now is indeed the time for high yield.

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