Unlocking the High Yield Bond Market

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Is There a Bubble in High Yield Bonds?
Exhibit 1

Yield-To-Worst: High Yield Master II Index and Five-Year Treasury Index Monthly, December 1996 – January 2013

Source: BofA Merrill Lynch Global Research, Used with Permission
Exhibit 2


Source: BofA Merrill Lynch Global Research, Used with Permission
Global Default Rate
Percentage-of-Issuers Basis
Annually, 1981 – 2012

Source: Standard & Poor’s
New Issuance vs Net Increase in Outstanding U.S. High Yield Bonds, 1999-2012

Sources: BofA Merrill Lynch Global Research, Bloomberg
Actual Spread minus Fair Value
Monthly, December 1996 - January 2013

Sources: BofA Merrill Lynch Global Research, Bloomberg, S&P, Federal Reserve
Conclusion:

• High yield is extremely rich because Fed’s low-interest rate policy is driving investors into risky assets.

• But buying is not driven by Greater Fool Theory
Has New Issue Boom Trashed Credit Quality?
Exhibit 6

Triple-C as Percent of High Yield Universe
By Face Amount, 1996 - 2012

Source: BofA Merrill Lynch Global Research, Used with Permission
Conclusion:

• Credit quality deterioration of high yield universe has been modest
• Caveat: Seasoning of new issues also matters
• Ratings mix changes driven more by upgrading and downgrading than by new issuer quality
Is LBO Volume about to Surge?
High Yield Spread versus LBO Volume
U.S., Annually 2001-2012

Sources: BofA Merrill Lynch Global Research, Used with Permission, Bloomberg

\[ y = 577.23e^{-0.003x} \]

\[ R^2 = 0.5311 \]
Conclusion:

• Modest rise in LBO volume likely in 2013
• Credit implications moderately unfavorable
For the Past Century Beginning
Yield Has Controlled Annualized
Return over Next Four Years
Quadrennial Promised and Realized Yields on Low-Rated Bonds

1912-1943

Source: W. Braddock Hickman, Corporate Bond Quality and Investor Experience (Princeton University Press, 1958)
Exhibit 9

Trailing-Four-Year Periods Beginning 1981-2009

Yield-to-Maturity and Annualized Return


Source: BofA Merrill Lynch Global Research, used with permission
Conclusion

• Expected return for 2013-2016 is 1.40% annualized
• Something exceptional must occur for high yield to earn the coupon over that period
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