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RISK & RETURN IN HIGH YIELD

Introduction

As we have written about a number of times in the past, risk in financial markets is often not smooth or symmetrical, instead alternating between tranquility and turbulence. Many times, when investors view risk as low – typically subsequent to a period of good returns and a strong economy – the risks looking forward are actually moving much higher. Likewise, the time of greatest opportunity is often when most market participants are scared and view risk as being high.

For example, in the high yield bond market, the "average" risk level does a poor job of describing the picture of this asset class' risk over time. Risk will often run along much lower than average while at other times it will jump to much higher levels. What is interesting is that risk usually does not sit at its average. We will make some observations about high yield risk and return, and show how they influence our investment strategy.

Risk is Cyclical

As Figure 1 shows, risk in the high yield market has recently been running at a low level, in fact close to its historical minimum. Risk has declined pretty smoothly from the elevated levels experienced in the early part of the decade. For comparison, we have also included the risk of the US equity market in the figure.

High yield clearly exhibits a similar pattern to equities. This should not come as a surprise, as high yield bonds have considerable equity characteristics. Although these bonds typically have coupon payments and are sensitive to interest rate movements, they are issued

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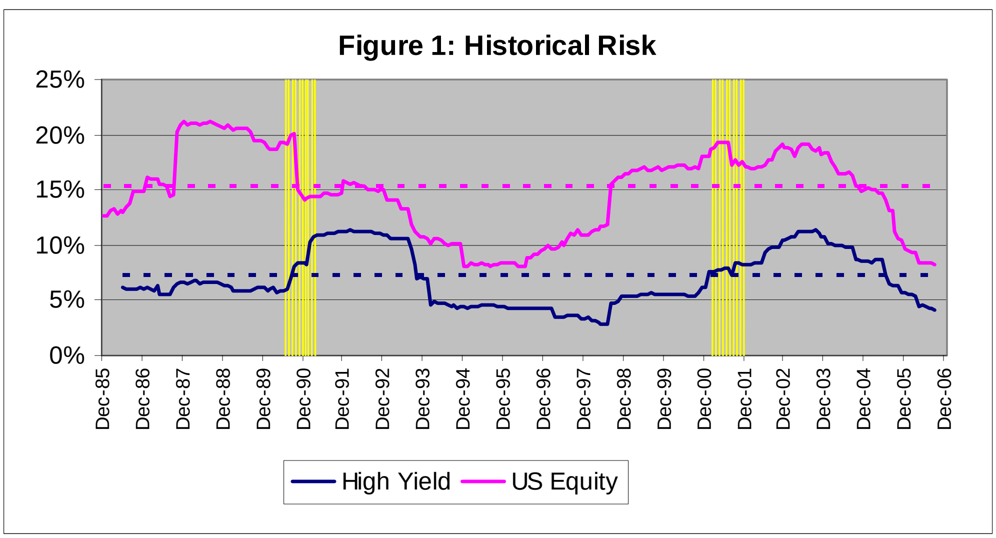


Notes: Risk is measured as the annualized standard deviation of 36 months of returns. Dashed lines show the average level of risk.

Sources: Russell, Lehman Brothers, NBER, Stairway Partners

CURRENT TOPICS

STRATEGY

If the rate of appreciation of the equity markets in the last three months is sustained, it will become increasingly likely that we will reduce exposure in these asset classes.

"MANY TIMES, WHEN INVESTORS VIEW RISK AS LOW, THE RISKS LOOKING FORWARD ARE ACTUALLY MOVING MUCH HIGHER"

RISK & RETURN IN HIGH YIELD - CONT'D

by highly-leveraged companies that do not carry investment-grade credit ratings. This leaves very little in the way of an equity "cushion" for the high yield bondholders if the companies' cash flows deteriorate. So, the odds increase that the bonds themselves will default, leaving the bond investor in a equity position - i.e. trying to recover what value is left in the entity.

Periods of increasing risk in the high yield market have often been associated with increased economic weakness. In Figure 1, we have shaded recessions with yellow to highlight this relationship. The economic reasoning is easy to understand: a weaker economy should produce weaker corporate earnings and cash flow. This will, in turn, reduce companies' ability to service their debt. Highly leveraged companies with poor credit quality will be especially prone to running into trouble and going into default. Figure 2 illustrates this point well.

Return Factors

The return on high yield bonds is driven by the same factors as returns on investment-grade bonds. The most important components are the interest payments and the repayment of principal. Investors should earn higher interest rates on high yield bonds than they do on investment-grade credits. This additional compensation is required for the greater possibility that the companies are unable to service their debt when they run into financial difficulty.

Often, the interest rate is decomposed into two pieces – the first being the underlying Treasury rate and the second the excess or spread over that Treasury rate for credit risk. This spread varies over time, and is typically driven by the economic and default environment, as well as the credit quality of the overall asset class.

Figure 3 shows that high yield spreads widen out substantially around recessions – times of financial stress – as investors demand more compensation for the increased precariousness of the bonds. This is also consistent with the increase in risk and defaults shown in Figures 1 and 2, respectively. It is interesting to note that spreads usually do not widen out *in advance* of rising defaults, but instead move higher in tandem.

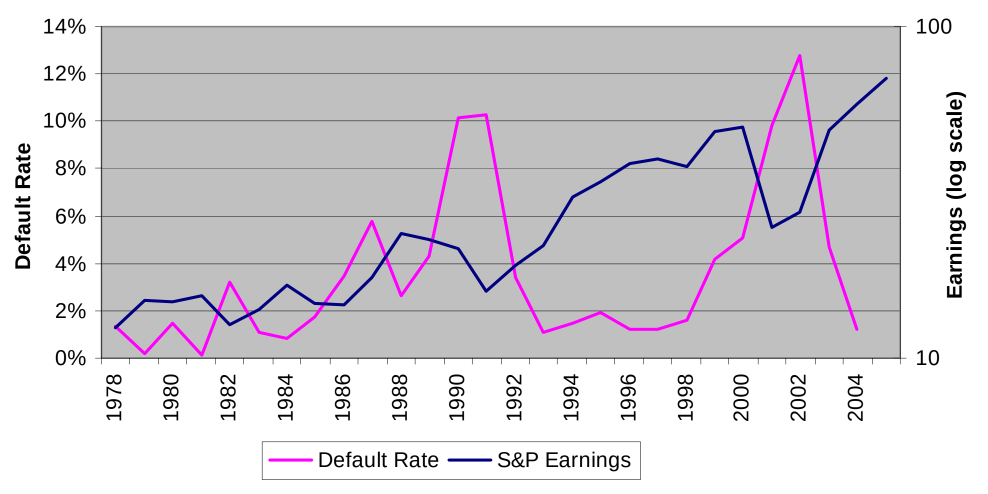
The second component to return is any change in the price of the bonds; clearly, returns are helped by capital gains and hurt by losses. In both investment-grade and high yield bonds, changes in interest rates will produce price changes. Higher rates cause bond prices to fall and declines in interest rates will push prices higher. In the high yield world, these interest rate changes can come from both changes in the underlying Treasury yield curve and changes in the spread. So, when spreads widen and the interest rate on high yield bonds increases, returns will be depressed due to capital losses. This pattern is evident in Figure 3.

The other big influence on high yield bond prices is defaults and recoveries. When a company defaults, there is obviously a direct impact on the bond holders – the bonds are worth less since the company has stopped paying interest on a timely basis. But, they often don't decline to zero. There is some "recovery" value – how much they're worth given investor expectations about prospects for the company (coming out of Chapter 11, for example). It is also important to note that, when default rates go up, volatility in the high yield market will spike, spreads will widen and returns will be poor.

Our Expectations

The current environment is one in which investors have pushed high yield spreads to very low levels. Figure 3 clearly shows that when high yield spreads over Treasuries

Figure 2: Defaults and Earnings



Sources: Standard & Poors, E. Altman (NYU), Stairway Partners

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

are low, the subsequent one year return is often poor.

What implications do these observations hold for prospective returns?

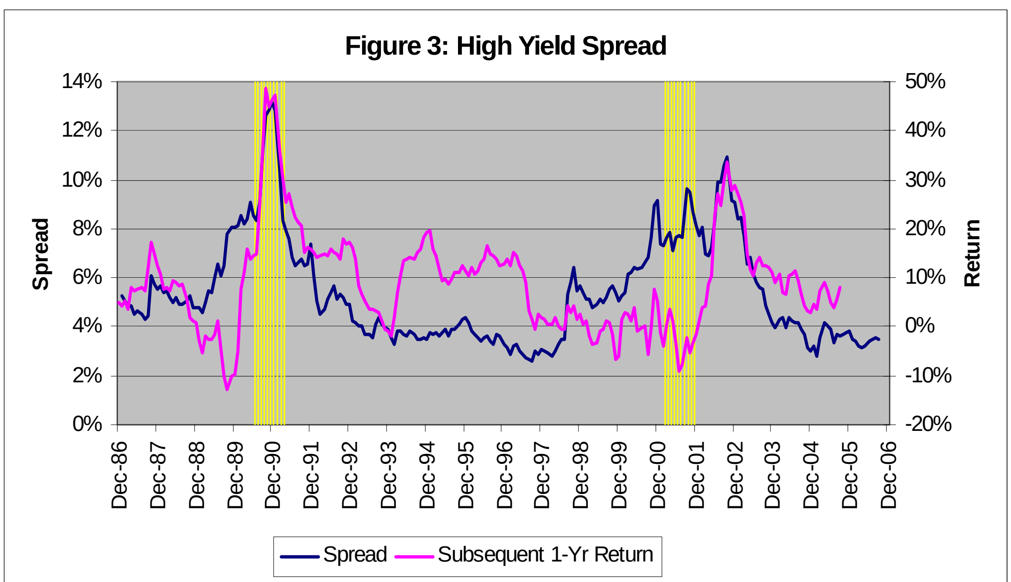
Given the low level of spreads over Treasury yields (and also the low level of longer-term interest rates), if there were to be no changes, the prospective return to high yield is well below its historical average and, we believe, inadequate compensation for its risk. Investors have driven high yield spreads to low levels because of the current calm risk environment and the low level of defaults recently. However, because issuing high yield bonds at tight spreads has been easy for companies to do, there has been a substantial increase in leverage. One only needs to look at the large increases in leveraged buyout activity for evidence of the expansion in low-quality debt.

Increased leverage has heightened the sensitivity of high yielding companies to the economic cycle. So, in addition to tight spreads adversely affecting our return expectations, any softening of the economic and earnings environment will cause the high yield market to deteriorate. When defaults pick up, investors will increase their demands for risk compensation, causing spreads to widen and prices to fall.

Strategy

We know that the high yield market is sensitive to the economic cycle and that we are currently "enjoying" a period of strong growth in earnings and cash flows. However, investors have priced the market as if they expect these good times to be sustained for a long time. Consequently, we view the compensation built into high yield bonds as woefully inadequate for any movement toward a more normal risk environment or economic slowdown.

Clearly, we believe that high yield risks are skewed to the downside rather than toward further improvement and continued strong returns. As a result, we have no high yield exposure in client portfolios. The risk to this strategy is that spreads remain low, or even tighten further, and it is many years before the economic cycle turns softer.



Sources: Lehman Brothers, NBER, Stairway Partners

"When high yield spreads over Treasuries are low, the subsequent one year return is often poor"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	4.0%	8.5%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	0.2%	7.3%		
Japan	-8.6%	4.5%		
UK	4.6%	8.5%		
Emerging	1.2%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.7%	4.6%		
5-Year	4.5%	4.8%		
10-Year	4.0%	4.9%		
30-Year	3.1%	5.1%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.5%	3.4%		
5-Year	3.6%	3.5%		
10-Year	3.8%	3.8%		
30-Year	5.8%	4.2%		
US High Yield	4.5%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.3%	4.4%		
Japan 10-Year	0.6%	2.1%		
UK 10-Year	3.4%	5.0%		
Emerging Markets Debt	3.5%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.2%	-3.0%	-0.9%	Close to fair value
Japanese yen	4.9%	-3.7%	5.5%	Yen is slightly attractive
UK pound	-5.2%	-0.6%	-1.7%	Pound is slightly expensive

Notes: **As of: 10/31/2006**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.