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GAINFUL PERIOD FOR HIGH YIELD

Market growth in 2004 set to top last year's record-setting levels of issuance

In 2003, the high yield market had a record amount of new issuance as 515 deals priced for a total of $141.1bn (€117bn) in proceeds, according to Merrill Lynch index data. The previous record of new issuance was in 1998, which experienced a sum of $140.9bn.

However, issuance in 2004 through March 31 is on pace to break last year's record as $46.3bn of new issuance has priced in the first quarter. According to Moody's Investors Service, the high yield market has grown in size from $452.1bn in 1998 to approximately $695.2bn at the end of March 2004, representing nearly 54 per cent growth. Incidentally, high yield bonds as a percentage of outstanding corporate bonds represented 17.8 per cent on March 31, 2004, according to Moody's.

'We are starting to see modest structural improvement in European high yield new issues'
Todd Youngberg, ABN AMRO Asset Management

TRENDS

A major difference between new high yield issuance in 1998 and 2003 is evident in the use of proceeds from new issuance. For example, in 1998, 38.8 per cent of all high yield new issuance proceeds were for either acquisition financing or capital expenditures. Companies were borrowing for tomorrow's growth prospects. However, in 2003, new issuance was largely characterised by a refinancing wave.

In 2003, only 8.6 per cent of new issuance proceeds were used for acquisitions or capital expenditures, however, 68.4 per cent of proceeds were used to refinance either bank debt or fixed interest debt. This compares to 42.3 per cent in 1998.

The focus lately has been on balance sheet de-leveraging, or lowering the average cost of capital, rather than using debt financing for growth. Company CFOs seem to be thinking a bit more rationally about their ability to service debt going forward. Incidentally, leveraged buyouts (LBOs) were a large proportion of new high yield issuance in the late 1980s. (This information is sourced from Merrill Lynch & Company data.)

The LBO wave peaked in 1989 as 32.7 per cent of all high yield new issuance proceeds were used to leverage the balance sheet with an LBO structure. In 1998, this proportion was only 4.8 per cent , and in 2003, it was only 5.2 per cent.

Lastly, we are starting to see modest structural improvement in European high yield new issues as structural subordination is being challenged from the investment community.

OUTPERFORMANCE

Historically, the high yield bond market has not behaved bond-like much at all. In fact, it could be argued that high yield is more equity-like than bond-like when looking at historical correlations between the asset classes. The table over illustrates that high yield has had a very low correlation with Treasuries (0.19), and a higher correlation to equities (0.50), which is still relatively low. Perfect correlation is 1.0.

CORRELATION OF MONTHLY RETURNS 1985 - MAR 31, 2004

	High Yield
Ten-year Treasuries	0.19
S&P 500	0.50

Source: Merrill Lynch Index Data

This is a powerful argument for an allocation to the high yield asset class within a balanced mandate. High yield is a distinct and separate asset class with returns that tend to be influenced more by factors unique to the asset class rather than by interest rate or equity market sensitivity.

In fact, one of the hot topics today concerns a strengthening US labour market and potential inflation, resulting in a rising interest rate environment and declining bond prices. How has high yield historically performed in a rising rate environment? We compared monthly data from the Merrill Lynch US High Yield and Ten Year Treasury Indices from January 1, 1985 through March 31, 2004.

Chart 1 illustrates that high yield has significantly outperformed US Treasuries in a rising rate environment. On average, when 10-year treasuries posted a monthly return of –4.0 per cent, high yield outperformed by approximately 3.5 per cent.

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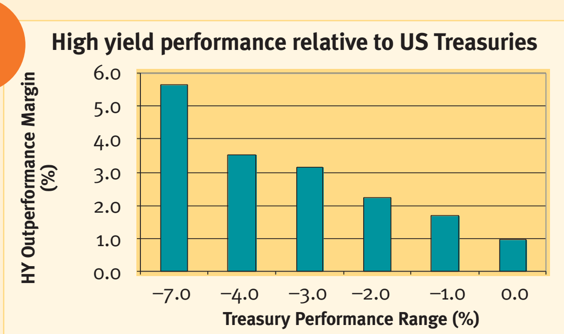

Source: Merrill Lynch Index Data

The month of April 2004 is a case in point. The yield on the 10-year treasury increased by 0.67 per cent during the month, providing a –4.8 per cent total rate of return for the index. However, the high yield market did not behave bond-like as it posted a –0.7 per cent return for the month. An allocation to high yield from treasuries would have improved performance.

A similar analysis can be made when comparing the returns in high yield to the equity market during periods of negative equity returns. Chart 2 illustrates that the high yield market has historically outperformed the S&P 500 Index during months of negative equity returns. April is another case in point as the S&P 500 Index posted a –1.6 per cent return while the high yield market posted a –0.7 per cent return, producing results consistent with our historical observations.

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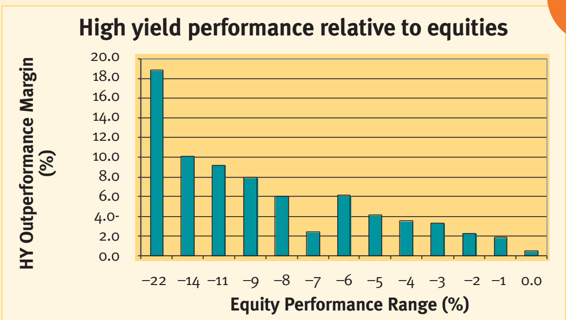

Source: S&P 500 Index; Merrill Lynch High Yield Cash Pay index

Having an allocation to high yield in a balanced portfolio of equities and bonds has historically improved the portfolio's risk/return profile. The simplified efficient frontier analysis in Chart 3 shows that having high yield in the portfolio has shifted the efficient frontier line up and to the left (see arrows pointing up and to the left), thereby increasing the portfolio's returns and reducing the volatility of those returns. This is largely because of high yield's low correlation to treasuries and equities, which has provided compelling diversification benefits. Of course, when allocating to high yield, we recommend a diversified approach to help capture the potential benefits of this unique asset class.

Todd Youngberg CFA, global high yield portfolio manager, ABN AMRO Asset Management

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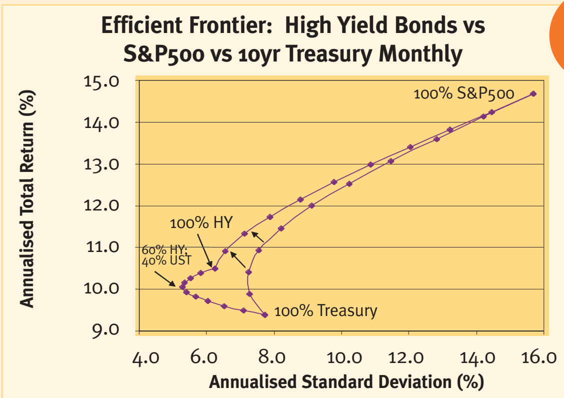

Source: Merrill Lynch; S&P