VANDERBILT Ave.
ASSET MANAGEMENT

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HIGH YIELD MARKET

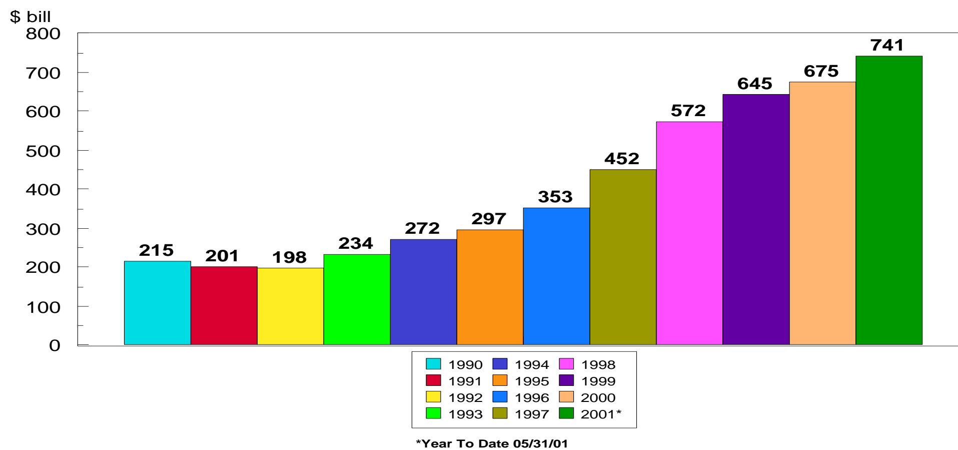
The following presentation of the High Yield market is constructed in two segments: (1) an **overview** of the market itself, answering the question ---Why such an investment is crucial to improving investment performance, while reducing market risk via diversification; and (2)---How does Vanderbilt Avenue Asset Management, LLC. approach actual **security selection**.

OVERVIEW

The High Yield bond market has grown dramatically totaling almost $750 billion today, up from $215 billion in 1990 and $30 billion just ten (10) years earlier. Narrowly defined, high yield bonds include all issues rated below investment grade, that is those which are rated Ba1 or lower by Moody's, BB+ or lower by Standard & Poor's, or those that are unrated. Over 85% of all U.S. public corporations, if they were to apply for a rating, would be rated below Investment Grade.

Chart I

High Yield Market

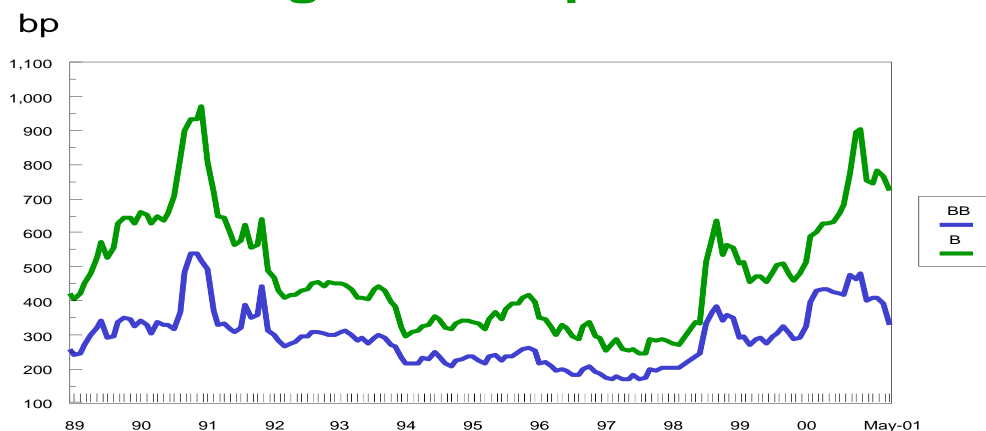


Yet the companies in this segment include many of the ones that are growing most rapidly and therefore are most in need of new capital. The rapid growth in the market has also fostered greater liquidity, due to the increased number of participants and larger issue size. In 1983, for example, 23 high yield deals sized at $100 million or greater came to market (26% of the new issue market) compared to 170 deals or 94.4% of all new issues in 2000. The average new issue size today is $277 million. In the past few years, the majority of new issue debt (56%) was used to refinance or repay outstanding debt, while approximately

21% was for internal growth and 23% of the total issued was for acquisitions. Moody's estimates that High Yield bonds total 18% of all corporate debt outstanding, down slightly from 19% in 1999 and 20% in 1998; the decline resulting from the substantial growth of the much larger investment-grade class. Nevertheless, it then follows that if less than 20% of a fixed income portfolio is in high yield bonds, it is under-weighted in the segment versus the market as a whole.

Why buy "High Yield" bonds? Because they offer the opportunity for better performance without undue risk, and a chance to earn an incremental rate of return compared either to risk-free Treasury bonds or investment grade issues. This premise has been validated consistently over the past years, and should continue to hold true because of the power of their income stream and the fact that there are institutions that cannot or will not participate in this area of the market. Generally, when risks are perceived to be high, the rewards are commensurate. For several years, the typical high yield bond has out-yielded long term U.S. Treasury bonds by 300-700 basis points. (See Chart II below.) Treasury bonds have obvious advantages, but from a performance standpoint, 300-700 basis points a year is difficult to overcome.

Chart 2



The three tables shown below present the academic case for investing in High Yield securities. Table 1 displays the correlation of monthly returns by selected asset class over the past fifteen (15) years. Interestingly, it demonstrates that High Yield bonds are much more closely associated to small cap stocks (.571) than other fixed income assets. As a consequence, they are less sensitive to interest rate fluctuations. Moreover, as Table II indicates, High Yield corporates over the same period had a .83% monthly return with a standard deviation risk measurement of 1.55%, better than the monthly return for High Grade bonds (.80%) and with a similar level of risk. High Yield also had a greater monthly return than ten-year Treasuries (.77%) which were characterized by a greater degree of risk (2.17%). In addition, when measured by rating class, BB bonds had higher returns and lower risk than Investment Grade fixed income assets as indicated by their Sharpe ratio of .27, a measure of their reward to volatility trade-off. (See Table III) Although BB spreads could widen a bit from their current 365 basis points, they appear to be priced attractively, and single B spreads are currently approaching the 750 basis point level. Comparatively, BBB rated issues often trade less than 150 basis points over Treasuries.

Table 1

Correlation of Monthly Returns

Selected Asset Categories (1985 - 2000)

	High Yield	Mortgages	10 - Yr Tsy	3 mo. Tsy	Big Stocks	Small Stocks	H/G Corp.
High Yield	1.000						
Mortgages	0.419	1.000					
10 - Yr Tsy	0.340	0.872	1.000				
3 mo. Tsy	0.009	0.364	0.324	1.000			
Big Stocks	0.508	0.268	0.286	0.017	1.000		
Small Stocks	0.571	0.112	0.100	-0.084	0.769	1.000	
H/G Corp.	0.529	0.900	0.934	0.299	0.373	0.217	1.000

Sources: Merrill Lynch, National Asso. of Securities Dealers, Standard & Poors, Ryan Labs.

Returns and Standard Deviations

Table 2

Selected Asset Categories (1985-2000)

	3 mo. Tsy	10-Yr. Tsy	Mortgages	H/G Corp.	High Yield	Small Stk	Big Stk
Avg. Monthly Return %	0.49	0.77	0.78	0.80	0.83	1.00	1.41
Standard Deviation	0.14	2.17	1.23	1.50	1.55	5.52	4.37
Sharpe Ratio*	N/A	0.13	0.23	0.21	0.22	0.09	0.21

Sources: Merrill Lynch, Russell Indexes, and Standard & Poors.

Table 3

By Rating Class (1989-2000)

	BBB	BB	B	CCC/CC/C	Master Index
Avg. Monthly Return%	0.72	0.78	0.72	0.46	0.83
Standard Deviation	1.30	1.17	1.86	3.02	1.55
Sharpe Ratio*	0.20	0.27	0.14	0.00	0.22

*Total Return minus Return on 91-day Tsy Bills / Standard Deviation of Total Return

Source : Merrill Lynch & Co.

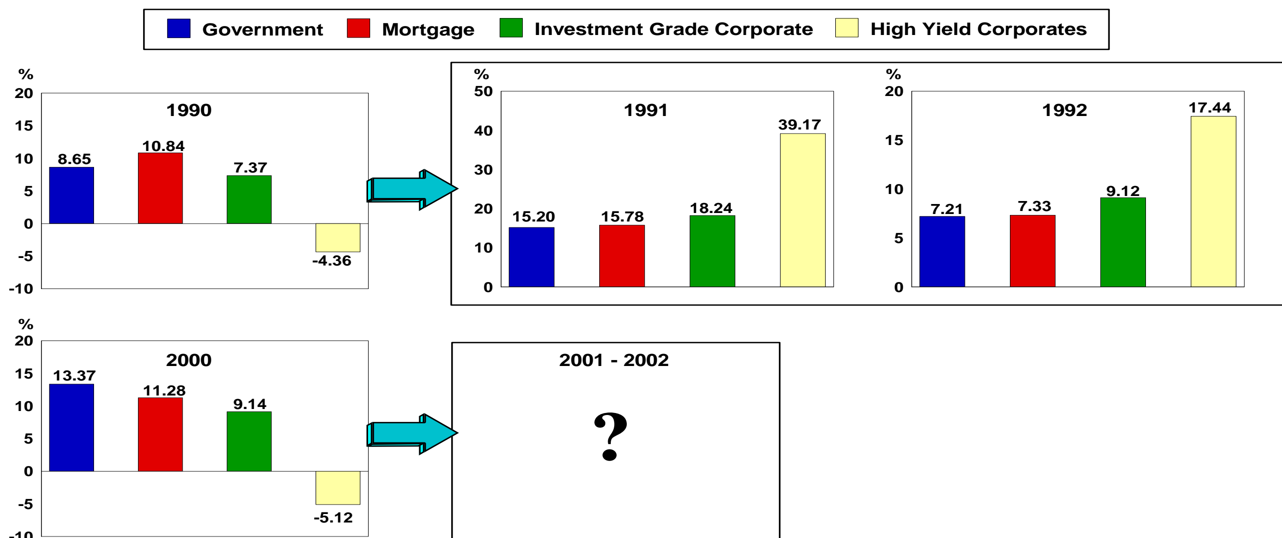
It is appropriate now to look at the risk side of the equation. As stated earlier, High Yield securities more closely correlate with small cap equities because both asset classes are derived from a similar universe, growth companies that need capital. If a company has significant value in the equity marketplace, it should enhance the value of a fixed income investment because the equity is the cushion below the debt. The wider and more stable that cushion is relative to the debt level, the better the creditor is protected as equity-holders will be more amicable in working out a restructuring to protect their subordinated investment position. Generally, high yield companies that have a low portion of debt to market capital outstanding are the most likely to be upgraded.

From a technical perspective things look positive for the High Yield market. While credit downgrades have significantly outnumbered upgrades at the rating agencies and default rates are up from prior years, these benchmarks are typically lagging indicators. High Yield mutual flows continue to add to liquidity, the quality of issuers has improved and portfolio managers are conservatively positioned in the marketplace. Moreover, even during an economic contraction, the total return of High Yield

securities tends, surprisingly, to remain positive despite the negative impact of spread widening. This seeming paradox is the result of higher coupon payments helping to offset the deterioration in spreads. However, while high yield bonds can have positive return premiums in recessionary periods, they do generally underperform Treasuries during a recession.

Ironically, the 3.2% default rate in 1982, the year of the worst economic contraction since the Great Depression, was slightly less than the 30-year average rate of defaults. The milder recession of 1991 coincided with the highest default rate in 50 years---exceeding 10%. Why the apparent disconnect? The market had become much riskier as the percentage of new issues rated B or lower during the late 1980's reached the lofty level of 66% of all debt issued in this sector. This largely reflected LBO financing as the takeover phenomenon reached its peak in 1988. Companies were encouraged to be more aggressive, both financially and strategically, by the easy availability of money. Moreover, firms' defensive moves led to deterioration in credit quality. Virtually all industrials that wished to remain independent were forced to consider defensive strategies. Moves to quickly boost shareholder values often come at the expense of debtholder's protection. Recent studies suggest that default rates lag debt issuance by about 3 years. The high level of new issuance of the late 1980s came "home to roost" with peak levels of default in 1990-91. The same can be said about the high level of issuance in 1997-98 coming home today. With the percentage of lower quality new debt issuance at moderate levels the past few years, risks appear to be within acceptable parameters, and in aggregate, the High Yield sector should outperform other fixed income assets with less perceived risk on a total return basis over the next several years.

Historical Sector Returns Point To Good Value And Excellent Opportunities In High Yield



Why High Yield May Outperform

- Substantial yield advantage - historic levels
- Continued rate cuts likely, both U.S. and Central Banks
- Liquidity returning to bond markets
- Excellent total return opportunities relative to equities
- Inflation remains under control
- Market has historically rallied in advance of an economic recovery

SECURITY SELECTION

For issue selection in the High Yield sector' has adopted the successful approach we use in the corporate bond sector. However, because the risk of holding bonds that may default is much greater, even more intense credit scrutiny is required. As with the investment sector, emphasis on cash flow and liquidity are paramount. Comparisons are made based on credit profiles versus a peer group and on upward credit momentum via earnings announcements. Three key credit measurements include (1) interest coverage by earnings before interest, taxes and depreciation (EBITDA coverage), (2) similar interest coverage but after capital expenditures (EBITDA-Capx coverage), and (3) debt maturing in the next few years to total debt. Those issuers that are selected have displayed a pattern of earnings above the concensus expectations, thus capturing the quasi-equity properties that High Yield bonds tend to exhibit. Research indicates that positive, as well as negative announcements, relative to concensus expectations, tend to exhibit recurring patterns. In this fashion, portfolios are constructed which exhibit solid, and improving credit fundamentals. Once purchased, issuers are continually monitored for any deterioration in credit measures. Such deterioration or negative earnings announcements would signal a sell candidate from the portfolio.

Investors in this area of the market must be aware of specific operating and credit variables. Because we are a research driven manager, we make every effort to understand the individual business characteristics of each debt issuer, as well as specific bond covenants. One of the most important factors we analyze in determining a company's well being is the quality of its' management. Successful companies have managers who anticipate problems and make the correct decisions as their industries evolve. Another tool in assessing a company's outlook and anticipating changes in credit quality is monitoring equity prices, as the debt of High Yield issuers has long been deemed to be an equity surrogate.

Clearly, investors are trying to improve their relative return performance and the High Yield market gains new disciples every year. Subject to an investor's particular portfolio constraints, we believe the High Yield market has excellent relative value. Although the possibility exists that spreads could widen further, it is a sound long-term investment strategy to establish a position in the High Yield market. However, close monitoring of economic conditions, credit quality and issue yield spread parameters remain paramount in achieving successful investment returns. Because of all the above we recommend an allocation of 5-10% in High Yield bonds within a "core" fixed income portfolio, in order to take advantage of the diversification benefit and incremental return they provide.

Vanderbilt Research Team

Emad A. Zikry

Chief Executive Officer
Vanderbilt Avenue Asset Management

Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as *The Journal of Forecasting*, *The American Economist* and *The Journal of Fixed Income*. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.