

Investing in High Yield Bonds

Can investors strike a balance between yield and risk?



Our high yield market outlook and strategy can be explained in the context of Fundamentals, Technical Factors and Valuations.

Striking a balance between yield and risk is always a concern for investors. The key question is, are they being paid for the risks they are taking? Over the past 24 months, the perception of risk in the global high yield market has changed dramatically, as has pricing. During this period, the global high yield market experienced a tremendous swoon and spectacular recovery. Looking into 2010, we expect there to be continued opportunities in this asset class with less volatility than we saw in 2009.

The 2009 rally was not just due to renewed investor confidence following unprecedented government intervention to restore liquidity to frozen credit markets. It also was fundamentally merited, based on improving corporate earnings and investor recognition that high yield bonds (securities rated below BBB- by S&P and Fitch, and Baa3 by Moody's) have senior claims to an issuer's assets compared to those of equity shareholders and holders of preferred stock. The result was that inflated yields, in conjunction with better downside asset protection, provided high yield investors with extraordinary risk-adjusted return potential.

The excellent balance of excess yield and moderate risk in the high yield asset class led to a 58.21% total annual return on the Merrill Lynch Global High Yield Index (the Index) as of December 31, 2009, the best calendar year return in the history of the Index. With increased investor understanding of the high yield asset class and low competing interest rate levels on bloated money market balances, investors steadily increased their allocations to high yield bonds throughout 2009¹.

Many investors have been wondering if it is too late to make an allocation to the high yield asset class. While total returns in 2010 are not likely to match those in 2009, the current yield on the Index of 9.06% (as of December 31, 2009) appears to be attractive for both yield driven and total return driven investors looking for strong returns with an improved claim on the assets of the underlying companies.

Even after the largest rally ever in the high yield market, we believe the high yield asset class can still outperform other traditional fixed income asset classes given the opportunities that exist today.

¹J.P. Morgan, Credit Strategy Weekly Update, January 15, 2010

Fundamentals

Recent economic data appears to have stabilized, and is, in some instances, improving. Expectations for economic improvement and improved earnings for many high yield companies bode well for the high yield asset class. Many high yield issuers have improved their balance sheets through stronger financial performance, increased liquidity and extended maturities.

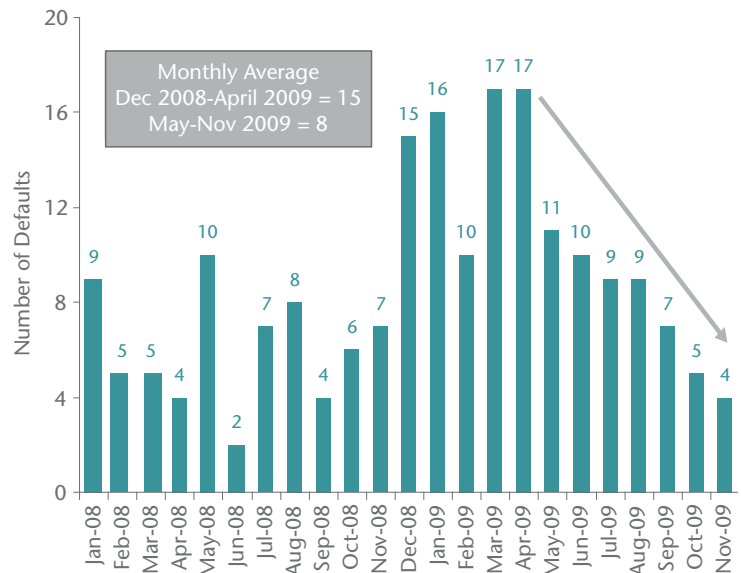
Default rates continue to be a key fundamental driver for high yield markets, given the negative impact defaults can have on portfolio returns. After six years of very low default rates (the average default rate was 1.4% from 2003 to 2008, according to S&P), the default rate rose dramatically in 2009. The current global default rate as of November 2009 is 12.7%, according to Moody's, more or less in line with the historical default rates during recessionary periods. In each month since April 2009, the number of high yield company defaults has declined (Exhibit 1). Looking forward, default rates, measured on a trailing 12-month basis, are expected to decline dramatically throughout 2010 as companies have been able to refinance their obligations and reduce their near-term maturities. Moody's expects the corporate default rate to decline to 4.0% by September 2010 citing the reopening of the capital markets and the improving global economy.

Technicals

Unusually strong investor demand for the asset class resulted in elevated cash levels held in U.S. high yield mutual fund portfolios at the start of the year. High yield issuers used this strong technical situation to issue numerous new bonds and improve their maturity and liquidity profiles. Because the new-issue proceeds have mainly been used for refinancing, strong technicals ultimately led to improved fundamentals. The amount of new cash invested in the high yield market through mutual funds alone in 2009 has totaled nearly \$30 billion versus a cumulative inflow of only \$6 billion in the five years prior (Exhibit 2). This strong inflow of cash should continue in 2010 due to the continuing lack of attractive yields in most competing asset classes. Net new high yield bond issuance will logically follow, but with only a modest amount of maturities in 2010, and balance sheet improvements are expected to continue.

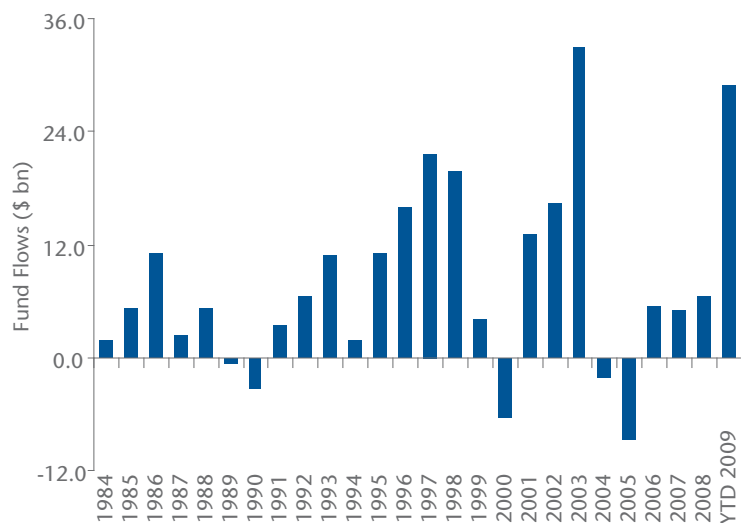
Default rates are expected to decline dramatically throughout 2010.

Exhibit 1: The Pace of Defaults Continues to Decline



Sources: J.P. Morgan, S&P LCD

Exhibit 2: High Yield Mutual Fund Flows



Sources: J.P. Morgan, AMG Data Services
As of November 2009

Valuations

At the end of November 2009, Index spreads were approximately 780 basis points (bp) above U.S. Treasury securities. In December 2008, in the thick of the credit crisis, spreads were around 2000 bp above Treasuries, their widest levels in history. Never before had spreads reached such levels, even in periods of crisis. To put the recent credit crisis into perspective, let's review how other periods of stress in the last 20 years impacted high yield spreads:

- In 2002, the Enron/Worldcom and the rest of the telecommunications bust sent spreads to around 1000 bp
- In 1998, the Long Term Capital Management collapse sent spreads to around 800 bp
- In the late 1980s, the Drexel liquidation caused spreads to shoot up to around 1000 bp

Even after 2009's unprecedented rally, Index spreads are still more than 150 bp wider than long-term averages. In the context of historical spreads, they are still at recession-level highs in the face of what is expected to be a modest economic recovery. In the past, the high yield market typically tightened during periods of economic growth. There is no reason why they should not continue to do so as the current economic recovery takes hold.

At 9.06%, the current yield on the Index will continue to draw investor attention as money market and saving yields remain near zero. Thus, while the high yield market has performed well, in our view, valuations still remain attractive given improving fundamentals and strong technicals. In summary, in our view, high yield bonds represent a compelling investment opportunity for investors in 2010.

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Investing with the Right Manager

Navigating the high yield market is not easy. You need a manager with significant experience in the market to help you differentiate good companies who issue high yield debt from those that are more likely to struggle and lose value, particularly in the current economic environment. Principal Global Investors has extensive experience managing high yield bond portfolios. We manage \$123.7 billion in fixed income assets*, primarily for retirement plans and other institutional clients, including \$13.1 billion in high yield assets.

Our experience in fixed income management spans multiple economic and credit market cycles, and encompasses all major fixed income sectors and security types. Security selection is central to our strategies, which are designed to deliver superior performance with below-average volatility. We draw on the strength of over 120 fixed income professionals, including a diverse group of global credit analysts, structured debt specialists, economists, portfolio managers, traders and risk management specialists. We conduct independent research on approximately 800 investment grade, 200 high yield, and 200 private placement bond issuers, and our global research effort spans sovereign and corporate debt markets in more than 50 countries worldwide.

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