HIGH-YIELD BONDS

MAKING THE CASE FOR HIGH-YIELD INVESTING

High-yield bonds may help diversify portfolios and have the potential to generate relatively strong returns during an economic recovery

WHAT ARE HIGH-YIELD BONDS?

High-yield bonds are a subset of corporate bonds that typically offer higher yields as a credit risk premium to compensate for the greater risk associated with the lower credit rating on the bonds. The bonds are rated by the rating agencies based on the issuer's creditworthiness, or its ability to pay principal and interest in a timely manner. All bonds rated below investment grade are considered high-yield bonds, or "junk" bonds. Some of these bonds are issued originally at the lower rating, while others are considered "fallen angels," or investment-grade bonds that have been downgraded to below investment grade.

BOND RATINGS

	MOODY'S	S&P/FITCH
Investment Grade		
Highest quality down to medium	Aaa, Aa, A & Baa	AAA, AA, A & BBB
Below Investment Grade		
Speculative	Ba	BB
More Speculative	B	B
Highly Speculative	Caa	CCC
High Risk of Default	Ca	CC

DIVERSIFICATION BENEFITS

The table on page 2 shows that high-yield bonds may offer diversification benefits due to their low correlation with both fixed-income and equity securities. As a result, adding high-yield bonds to a portfolio may reduce expected risk and may potentially increase returns. High-yield bonds can behave as a hybrid between fixed income and equity and offer diversification benefits when paired with most asset classes. Diversification does not guarantee a profit nor protect against a loss. Past performance is no guarantee of future results.

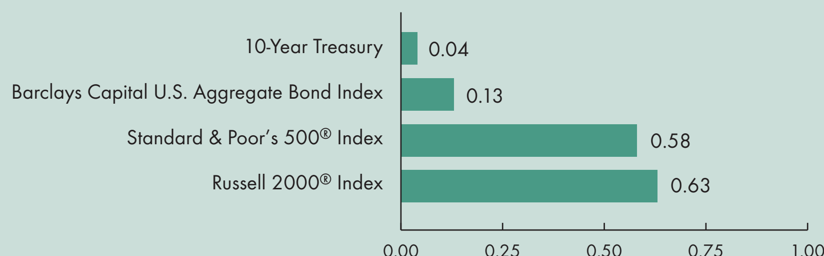
At the same time, there is a risk/reward tradeoff when investing in high-yield bonds. In return for the potential to earn higher yields than what investment-grade bonds typically offer, investors in high-yield bonds also assume the potential for greater credit risk. For example, the issuer could default and the bondholder will not receive payments of interest and principal when due.

CONTINUED

Returns for high-yield bonds are generated by two components: income generation and price appreciation.

HIGH YIELD'S LOW CORRELATION TO FIXED INCOME AND EQUITY

Barclays Capital U.S. Corporate High Yield Bond Index Versus Major Asset Classes (20-year correlation 1/1/89 – 12/31/08)



Source: Northern Trust

A correlation of 1.00 indicates that asset classes are perfectly correlated and move together in the same direction. High-yield bonds have a low correlation to fixed-income securities, as represented by the 10-Year Treasury Index and the Barclays Capital U.S. Aggregate Bond Index, a measure of investment-grade fixed-income securities. High-yield bonds have a higher correlation to equity securities, as represented by the S&P 500 Index, a common measure of the U.S. stock market, and the Russell 2000 Index, a measure of small-capitalization stocks.

Please see page 4 for index definitions.

COMPONENTS OF RETURNS

Returns for high-yield bonds are generated by two components: income generation and price appreciation. High-yield bonds are like other fixed-income securities in that they are designed to generate a steady stream of income based on the stated coupon of the bond. The second component of return is the potential for price appreciation, which is driven by improved overall economic and market conditions or by upgrades in credit ratings by the rating agencies.

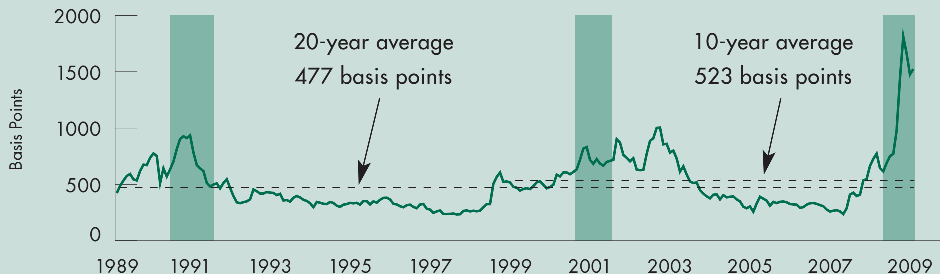
BEHAVIOR OF HIGH YIELD

In a typical recessionary cycle, the Federal Reserve decreases interest rates as a way to stimulate the economy. Bond prices rise as a result of the declining interest rates; therefore, investment-grade bonds generate relatively strong returns during a recession. But as demonstrated by high-yield bonds' higher correlation to equity securities, high-yield bonds have similar sensitivities to corporate earnings. As a result, high-yield bonds typically *underperform* higher quality bonds during an economic contraction.

While high-yield bonds are similar to equity, they tend to be less volatile because they are designed to generate a steady income stream, which typically is higher than the dividends paid by stocks. In addition, high-yield bonds offer lower overall risk versus equities, given that bond holders are paid ahead of equity shareholders should bankruptcy occur. As the chart on page 3 illustrates, yield spreads of high-yield bonds compared to Treasury bonds historically have widened during recessions and narrowed as the economy improved.

HIGH YIELD SPREADS

Historically, high-yield spreads versus Treasury bonds have widened during recessions and narrowed as the economy recovered. (3/31/89 – 2/28/09)



Source: Barclays

One basis point = 0.01%

Recessionary Period

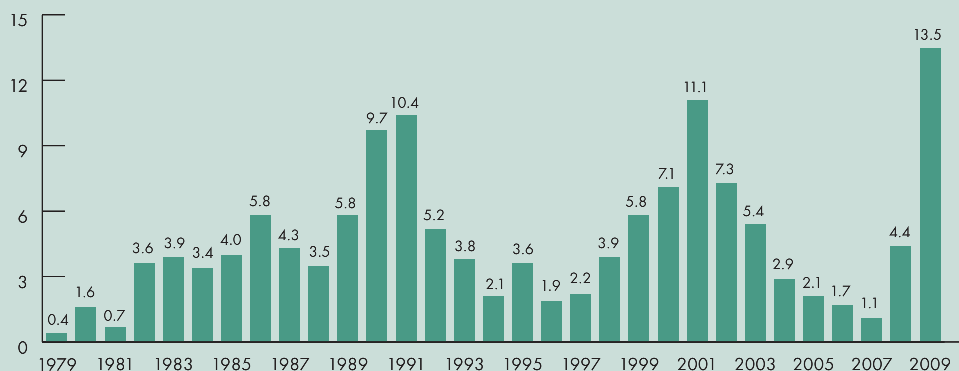
On a relative basis, high-yield bonds have generally outperformed high-quality bonds in periods of economic recovery.

After recessionary periods, high-yield bonds have the potential for strong price appreciation as the economy begins to expand and corporate earnings improve, possibly leading rating agencies to upgrade their bond ratings. On a relative basis, high-yield bonds have generally outperformed high-quality bonds in periods of economic recovery.

Keep in mind that default rates remain an important driver of high-yield returns. The average default rate for the past 20 years is 4.8%, but the estimated default rate for 2009 is much higher: 13.5%. Default rates typically rise as the economy moves further into a recessionary cycle as firms experience cash flow problems and are unable to pay bondholders.

Default rates and high-yield spreads are correlated during recessionary periods, with spreads widening to incorporate the additional risk premium for the higher default rate in the market. Therefore, credit selection is vitally important, and a diversified portfolio may help reduce the associated risk.

HISTORICAL HIGH-YIELD DEFAULT RATES



Source: Moody's

FOR MORE INFORMATION

To learn more about the potential benefits of high-yield bonds and whether investing in this asset class may be appropriate for your portfolio, visit northerntrust.com or contact your Northern Trust relationship manager.

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Bond Risk: Bond funds tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. The fund's income may be subject to certain state and local taxes and, depending on your tax status, the federal alternative minimum tax.

High-Yield Risk: Although a high-yield fund's yield may be higher than that of fixed-income funds that purchase higher-rated securities, the potentially higher yield is a function of the greater risk that a high-yield fund's share price will decline.

Barclays Capital U.S. Corporate High Yield Bond Index is an unmanaged index of prices of U.S. dollar-denominated non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. It is not possible to invest directly in an index.

Barclays Capital U.S. Aggregate Bond Index is an unmanaged index of prices of U.S. dollar-denominated investment grade fixed income securities with remaining maturities of one year and longer.

S&P 500® Index is an unmanaged index consisting of 500 stocks and is a widely recognized common measure of the performance of the overall U.S. stock market.

Russell 2000® Index is an unmanaged index which measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

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