"Advancing Your Investments"
NEW ENGLAND PENSION CONSULTANTS

To: NEPC Clients

From: NEPC Research Staff

Date: May 6, 2004

Subject: High Yield Market Update

We would like to update our clients on the latest developments in the high yield bond market. This marks the third time in eighteen months that we are writing to you regarding this asset class.

High Yield is a staple of our diversified portfolio recommendations due to its income advantage over treasury bonds. NEPC had identified significant capital gain opportunities in the fall of 2002 and were more aggressive in recommending it to our clients. As is typically the case, this opportunity presented itself at the point of maximum pessimism. After the Enron, Worldcom and Tyco scandals broke, prices for all corporate paper tanked, especially the high yield variety.

Since publishing our positive outlook on high yield in the fall of 2002, high yield bonds have returned 40.9% through March 31, 2004 (LB High Yield Index). As we will show, a significant portion of the capital appreciation opportunity has passed. The remaining opportunity is the traditional income advantage of the higher coupon payments from the asset class.

Therefore, we believe clients should ensure they have no more than their target commitment to the asset class. For those clients that allocated additional monies into high yield twelve or eighteen months ago, the time has come to adjust that allocation back to a more traditional level.

Importantly, any client reducing their allocation to high yield, whether through rebalancing or a reduced target, *should look to re-allocate those profits to additional diversifying asset classes or strategies*. If possible, these profits should not be allocated to investment grade bonds as the outlook on that asset class remains poor.

The remainder of this paper discusses the high yield market characteristics in more detail. The data supporting our recommendations above are also provided. If you have any questions, please contact your NEPC consultant at (617) 374-1300.

Market Re-Cap

2003 proved to be a phenomenal year for high yield bonds with the major high yield indices posting the second highest returns in the history of the asset class. The various high yield indexes returned between 28% and 30%. Telecommunications, cable/satellite television, and utilities were the top industry performers as each returned over 45% for the year. As you may recall, these same industries experienced the highest default rates in 2002.

As shown in Figure 1, high yield spreads tightened dramatically since October of 2002.

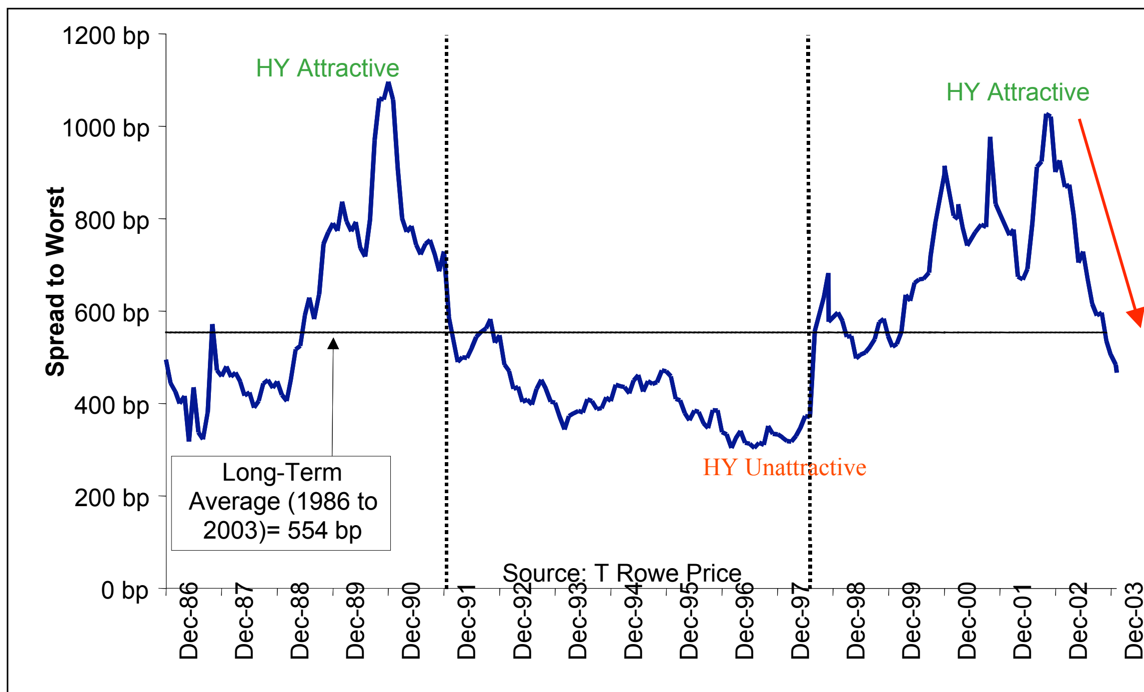


Figure 1. High Yield Bond Spread Versus US Treasury Bond Yield.

Interestingly, the indices were clearly bifurcated with lower quality credits dominating in 2003 as shown in the table below.

Credit Rating	Total 2003 Return
Merrill Lynch HY Master II Index	28.2%
BBB	11.5%
BB	19.5%
B	26.0%
CCC/CC/C	61.0%

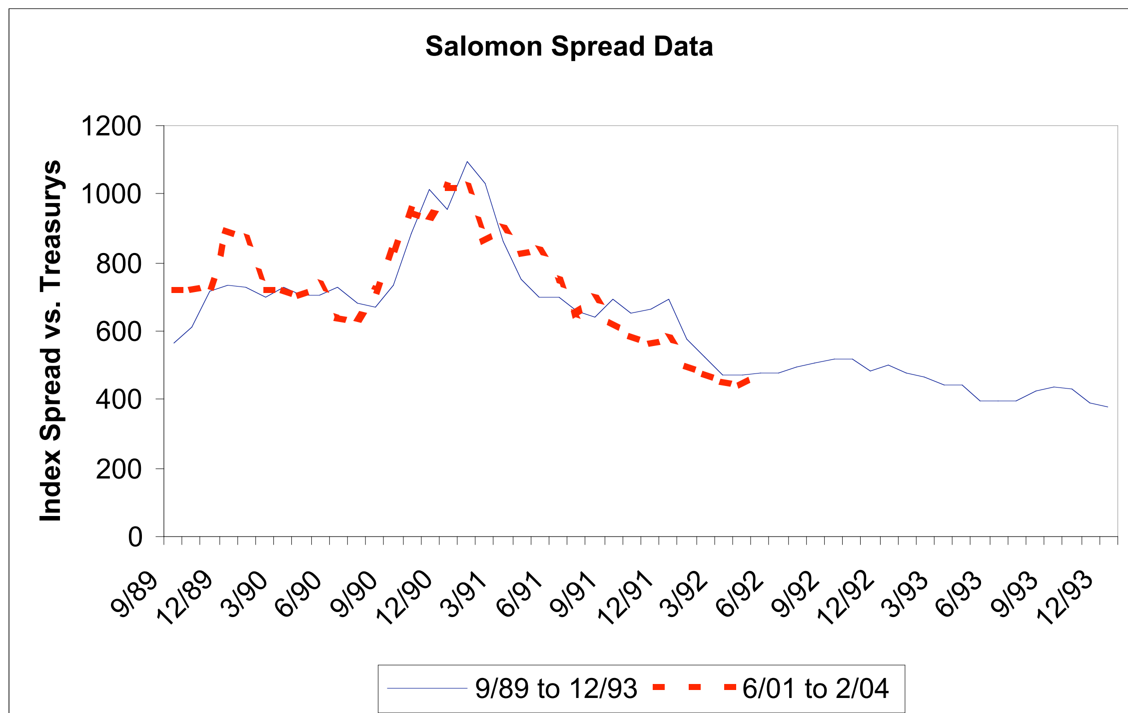
Source: Merrill Lynch & Co., Standard & Poor's.

There were some major developments within the high yield market over the trailing year. Inflows into high yield mutual funds set a new record during 2003 with $32.8 billion entering the market. Global new issuance also set a new record with a total of 515 issues representing $141 billion in assets. The majority of new issuance has been to refinance existing debt. Default rates improved substantially, dropping from 8.4% in 2002 to 5.2% in 2003.

Historical Context

Many investors are drawing similarities between the 1991-1992 market and today. 1991 is on record for posting the highest return in the history of the high yield asset class with the CCC/CC/C portion of the market leading the way.

Figure 2 below shows the similarities between the 1989-to-1993 period and 2001-to-2004 period. The chart shows the similar pattern of high yield spreads widening and tightening versus treasuries.



Source: Fountain Capital Management

Figure 2. Comparing Today's Spread Cycle with Prior Spread Cycle.

As the economy gradually improved after the 1991 recession, high yield spreads continued to tighten marginally. While we would like to see this trend hold over the next few years, future spread changes will depend on the progress of the current economic recovery.

Market Outlook

With the significant positive movements in the market place, the obvious questions are, *"Where does the high yield market go from here?"* and *"Is there still opportunity in the asset class?"*

As of March 31, 2004, the yield on high yield indices ranges from 7.5% to 8.0%, compared to 3.9% for the Lehman Brothers Aggregate Index. The economy and corporate earnings are improving. Default rates in high yield are declining. These factors bode well for realizing most of the yield advantage from a high yield portfolio over the next year.

However, the capital gain opportunity is largely behind us. According to T. Rowe Price, more than 85% of the issues in the high yield universe trade at or above par as of early 2004. As you know, bond prices can rise above par, but only marginally. The bonds will either be recalled or re-financed at lower rates. Additionally, the market is nearly unanimous that interest rates will be rising over the next year. While rising interest rates do not affect the high yield market as much as the high grade market, it does have a negative effect and could lead to some capital depreciation.

Almost the entire return of investing in high yield asset class over the long term comes from clipping coupons. Avoiding defaults is the best way to ensure that yield over time. From time-to-time, a capital gain opportunity presents itself, but we believe that time has passed. NEPC expects the asset class to deliver 7.5% to 8.0% in 2004 and beyond.

NEPC Recommendation

Given that a significant portion of the capital appreciation opportunity in high yield has passed, the remaining opportunity is the traditional income advantage of the higher coupon payments from the asset class.

Therefore, we believe clients should ensure they have no more than their target commitment to the asset class. For those clients that allocated additional monies into high yield twelve or eighteen months ago, the time has come to adjust that allocation back to a more traditional level.