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ASSET ALLOCATION

3 Where Have All the Good Bonds Gone?



There have been major structural changes in the composition, complexity and liquidity dimensions of the U.S. bond market in recent years, forcing changes in investment manager styles and philosophies. Investors need to reconsider investment manager styles that worked well in the past and whether they will do as well in this new environment.

7 A Horse of a Different Color

A dark horse entry in the asset class derby is the little-known area of private mezzanine securities. These exotic-sounding investments lie outside the traditional box of public equities and bonds, but they offer the potential for strong risk-adjusted returns in a low-yielding investment environment.

10 Micro-Caps for the Institutional Investor

Micro-caps can add a variety of benefits to the institutional investor's overall portfolio. Yet despite the compelling advantages, there are relatively few managers who focus on this asset class. The unique characteristics and small number of micro-cap strategies make it necessary for institutions or their consultants to actively pursue these sought-after managers.

26 Effective Team Leadership

If you want team personnel to contribute discretionary effort to the job, join the "New School" of management. It may require some repetitive leadership training to eliminate the old habits, but these new techniques may be learned by open-minded managers who are willing to proactively leave the "Old School" approach behind.

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Where Have All the Good Bonds Gone?

By Robert G. Smith III

Investors today are faced with an increasing array of difficult challenges and trends. This is particularly true for those who seek investment opportunities in the U.S. domestic bond market. With a market valuation of nearly \$15.5 trillion at year end 2000, representing over 50 percent of the world bond market, one would think that finding a high-quality (AAA) corporate bond to invest in would be an easy exercise. Not so. Even though the corporate

bond market represents nearly one third of the U.S. domestic bond market, finding an "old fashioned" Aaa rated U.S. industrial, utility or bank bond is almost the equivalent of sighting a Sasquatch in the woods.

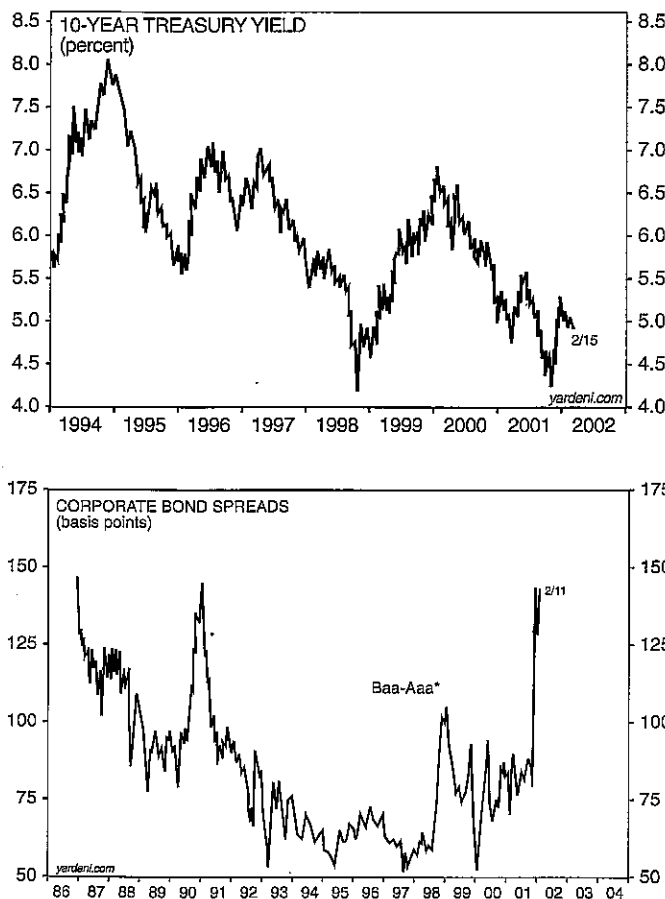
In the main, this situation is largely attributable to a secular trend over the last two decades toward increased leverage and dependence upon debt capital to support operations by American corporations. Most bond investors ignored this trend throughout the

1990s. Indeed, as shown in figure 1 below, interest rates declined throughout the decade, but so did the yield spread between Aaa and Baa corporate bonds. The combination of these two trends led to some of the best returns realized by corporate bonds over the past three decades.

What Risk?

Not unlike stock valuations, corporate bond yield spreads reached extraordinarily narrow and expensive levels by historical standards. The "new paradigm" thinking that was then pervasive in the equity market which pushed P/E valuations sky high was also apparent in the corporate bond market. Unfortunately, this experience was not supported by strong corporate balance sheet fundamentals but rather by a combination of supply and demand factors that were at work in the marketplace. For example, according to the U.S. Federal Reserve Bank, demand for U.S. fixed income products by foreign investors rose dramatically during the 1990s. Foreign net capital flows into the U.S. bond market grew by \$100-300 billion annually over this period. Foreign ownership of the U.S. bond market grew from 21 percent in 1990 to 36 percent by year end 2001. Moreover, foreign ownership of the U.S. corporate bond market rose from less than 12 percent in the early 1990s to nearly 25 percent by the end of last year. These factors contributed greatly to tighter spread valuations in the corporate bond market. Additionally, the decline of the relative size of government securities market and reduced issuance versus other domestic bond sectors also contributed to tighter corporate bond valuations. As shown in figure 2, government bonds (i.e.,

Figure 1



* Source: Moody's Investors Service. Aaa-rated and Baa-rated corporates with maturities of 25 years or more.

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Treasuries and Agencies) now constitute far less of the overall market than at any time since the early 1980s. More importantly, the mortgage-backed securities market has now become the single largest segment of the U.S. bond market followed by the euro dollar (offshore) sector, finance and corporate non-finance sectors.

For investors there are several significant implications that arise from these trends. First, the relative decline in the availability of the risk-free asset (i.e., Treasuries) was one of the broad themes within the U.S. bond market over the last decade. Second, structured and/or derivative and credit risk securities are on the rise. Third, the U.S. bond market has truly become a global arena both in terms of investor participation and issuer base.

It is also important to note that throughout this period of change, the number of U.S. bond market intermediaries supporting the market declined dramatically. For example, the number of primary U.S. Government Bond Dealers has now reached a twenty-year low. By the end of 2001 there were fewer than twenty-five firms in this august group, many of which were foreign owned or controlled institutions. This is far below the forty-five dealers that participated in this market as recently as the late 1980s. The same trend has been apparent throughout the other key sectors of the U.S. bond market where consolidation and discontinuance of bond-dealing operations have been

dominant trends. This reduction in inventory and positioning capacity within the bond-dealer community has adversely affected market liquidity as well as security marketability. Hence, bond investors have, and will continue to face, rising transaction costs by virtue of wider bid/offer trading spreads in the corporate bond market to compensate dealers for diminishing inventory capacity and market risk.

They Ain't Making 'Em Like They Used To

Despite the favorable returns generated by most sectors of the investment grade corporate bond market in recent years, there has been a disturbing underlying trend that most investors have ignored. That trend has been the inexorable decline of corporate credit quality. Over most of the 1990s, credit spreads tightened to historic lows but, the ratio of bond rating downgrades by

Moody's and S&P rose from less than 0.5:1 to 7.5:1 by the close of 2001. Admittedly, this trend accelerated subsequent to the financial crises of the Asian Contagion, LTCM and the Russian debt default, and quality spreads widened out in response. Nonetheless, investors need to be aware of the fact that these conditions have brought about dramatic changes in the structure and character of the bond market indexes that most investment results are compared against.

A good example of this is presented in figure 3, which identifies the historical migration of credit quality in the Lehman Brothers Credit Index since its inception.

According to this chart it is clear that high-quality corporate bonds are a dying breed and that riskier BBB securities are becoming a dominant reality in the U.S. corporate bond market. In fact, the lower half (i.e., A-BBB rated) of the market now rep-

Figure 3: Quality Analysis of the Lehman Brothers Credit Index, 1973–January 31, 2002

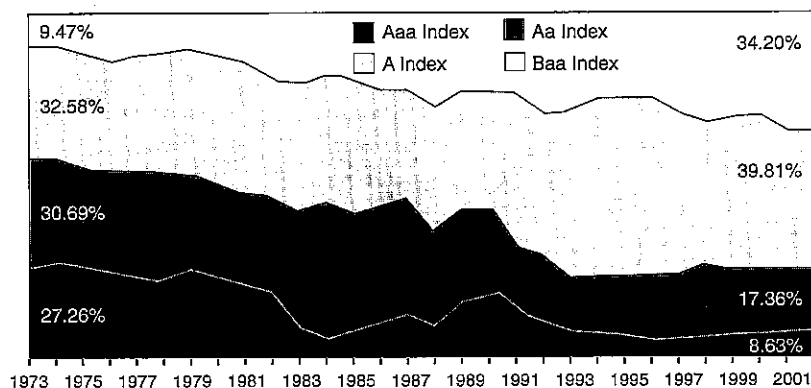


Figure 2: U.S. Bond Market Historical Sector Distribution (percent Market Share by Sector)

	Total Size	Tsy	Agcy	MBS	Muni	Corp.-Fin.	Corp. Non-Fin.	Foreign	Euro \$
1980	\$1,485.2B	27.4%	11.1%	7.7%	19.4%	6.3%	24.3%	N/A	3.9%
1985	\$3,396.5B	30.6%	7.7%	10.9%	18.6%	6.3%	16.4%	1.8%	8.0%
1990	\$6,281.9B	26.6%	6.3%	16.2%	16.9%	8.6%	15.3%	1.8%	8.3%
1995	\$9,634.0B	26.4%	8.7%	16.3%	12.1%	12.5%	14.0%	3.0%	7.1%
2000	\$15,417.5B	14.9%	12.0%	16.2%	8.9%	14.8%	14.5%	3.2%	15.4%
Trend		Down	Up	Up	Down	Up	Down	Flat	Up

Source: Merrill Lynch & Co.



resents nearly 75 percent of the Lehman Credit Index, up from only 42 percent less than three decades ago. Unfortunately, most investor's portfolio investment guidelines and restrictions have not come to grips with these facts. Indeed, those investors who traditionally restricted themselves to the high-quality sectors of the corporate market may now find that locating a diversified inventory of high-quality corporate bond alternatives may be akin to looking for a needle in a haystack.

The decline in the number of available high-quality corporates has also affected the representative quality of several bond market indexes. For instance, the Merrill Lynch AAA Corporate Bond Index has undergone significant change since its inception. As shown in figure 4, the number of issues to create the index has declined from 549 in 1988 to just 85 by year end 2001. Moreover, the number of U.S. domestic corporations that carry the much-heralded Aaa/AAA bond credit rating within this index has dwindled to just six compared to many more in the past. The remaining members of this rare breed of corporation are Bristol-Meyers, General Electric, Johnson & Johnson, Merck, Pfizer and Exxon-Mobil.


In view of the AAA index trend, the coincidental rise in the number of issues used to create the Merrill Lynch BBB and High Yield Indexes should not be a surprise to investors.

Moreover, the number of issues in the BBB index is likely to grow further if the rating agencies maintain recent trends and act on a variety of sizeable potential downgrades in the single A category that are currently on negative watch. As a result, we expect further bifurcation of the high-grade corporate bond market in the months ahead. This also means that rare and richly priced high-quality corporate paper will trade well while lower quality investment grade corporates will languish.

What Does It All Mean?

Clearly, there have been major structural changes in the composition, complexity and liquidity dimensions of the U.S. bond market in recent years. These changes will remain and continue. As such, investors need to update their investment policies, guidelines and analytic capabilities to reflect these market conditions. In our view, most investor bond investment guidelines are woefully behind the times and not reflective of the new risks present in the U.S. bond market. These significant changes in the bond market's structure and security availability are forcing change in investment manager styles and philosophies. Given these considerations and the fact that the long-term secular decline in U.S. interest rates may be close to bottoming (if it hasn't done so already), we think investors need to reconsider investment manager

styles that worked well in the past and whether they will do as well in this new environment. In our view, the important message in these environmental and structural market changes is that due diligence on investment manager styles, investment security structural risk and independent security pricing/valuation will be as important as ever for investors.

Lastly, the favorable returns provided by high-quality corporate bonds in recent years might not be as attractive over the next few years. Therefore, since investors will be increasingly forced to consider lower quality alternatives for return it will be important for them to focus not just on their "relative total return" potential but also on the certainty and consistency of the absolute returns or cash flow afforded by such investments. After all, the purpose of most fixed-income allocations within investor portfolios is to provide consistent cash flows and eventual return of principal. These goals will not change in the future, but the way in which they will be attained within the U.S. bond market has. If investors gain a better understanding of the risks associated with these structural and credit-risk changes in the U.S. bond market, they will inevitably be better prepared to meet the challenges those changes present. 

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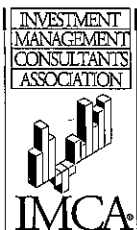
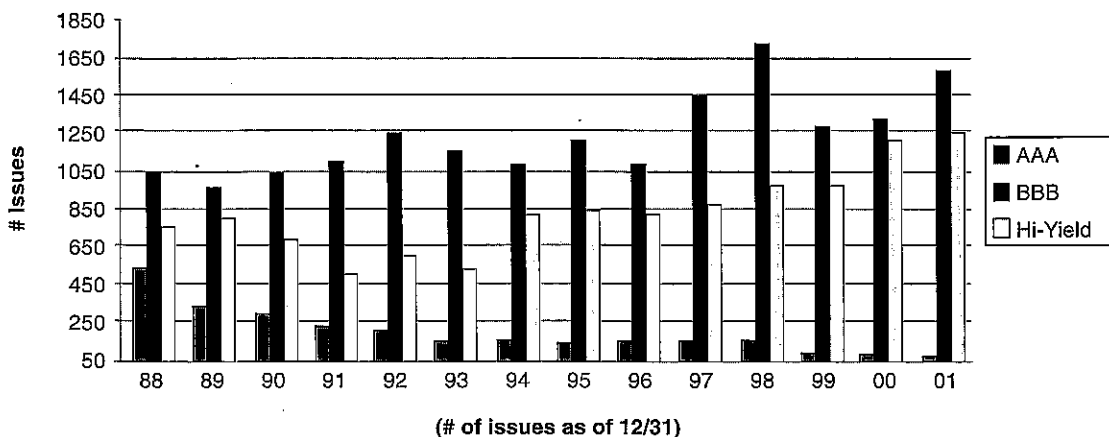


Figure 4: Historical Number of Issues



Source: Merrill Lynch & Co. Global Market Indices