

Stephen L. Kessler Award Winners Named

Stephen Kessler, CIMA[®], was the first volunteer *Monitor* editor who generously gave of his time to make the *Monitor* the excellent publication investment consultants rely on. As a way of thanking Steve for his service, the board of directors named a special writing award after him, an award that recognizes exceptional original *Monitor* articles. The 2003 Kessler Award winners were announced at the Consultants Conference in Monterey, California.



HONORARY DISTINCTION
ROBERT G. SMITH, III, CIMC

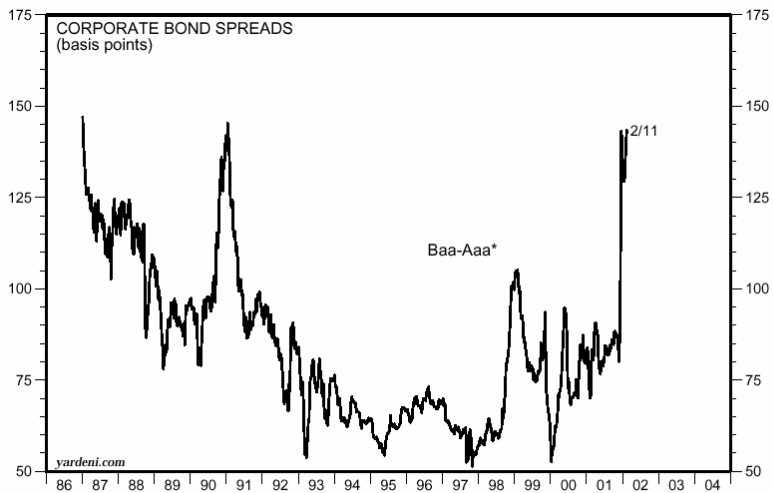
“Where Have All the Good Bonds Gone?” — Another winning article because it challenged investment consultants to focus not just on relative total returns but also on the certainty and consistency of the absolute returns and the cash flow affected by the investments. This article appeared in the September/October 2002 *Monitor* issue.



Where Have All The Good Bonds Gone?

Investors today are faced with an increasing array of difficult challenges and trends. This is particularly true for those that 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% the world bond market, one would think that finding a high quality (AAA) corporate bond to invest in would be an easy exercise. "Au contraire mon frer", 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 1990's. Indeed, as shown in the chart below, as interest rates declined throughout the decade 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.



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

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 1990's. 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% in 1990 to 36% by year-end 2001. Moreover, foreign ownership of the U.S. corporate bond market rose from less than 12% in the early 1990's to nearly 25% 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 on the chart below, government bond (i.e. Treasuries and Agencies) now constitute far less of the overall market than at any time since the early 1980's. 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.

U.S. Bond Market Historical Sector Distribution

	Total Size	(% Market Share by Sector)							
		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.

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.

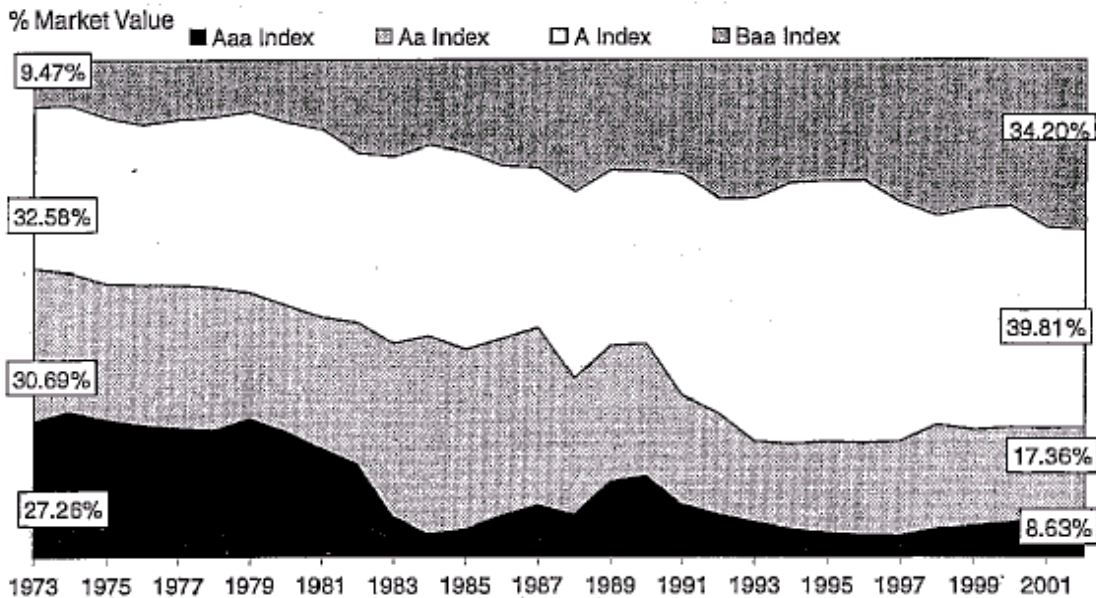
It is also important to note that, throughout this period of change, the number of U.S. bond market intermediaries supporting the market declined dramatically. For example, the number of primary U.S. Government Bond Dealers has now reached a 20-year low. By the end of 2001 there were less than 25 firms in this august group, many of which were foreign owned or controlled institutions. This is far below the 45 dealers that participated in this market as recently as the late 1980's. 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. The consequent 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 positioning risk.

They Ain't Making 'Em Like They Use 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 the 1990's credit spreads tightened to historic lows but the ratio of bond rating downgrades versus upgrades, by Moody's and S&P, rose from less than 0.5:1 to an alarming 7.5:1 by the close of 2001. Admittedly, during this same period investors were dealing with the Asian Contagion, LTCM implosion, the Russian debt debacle: and in response, yield spreads appropriately, widened between high and lower quality bonds. 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 the following chart which identifies the historical migration of credit quality in the Lehman Brothers Credit Index since its inception.

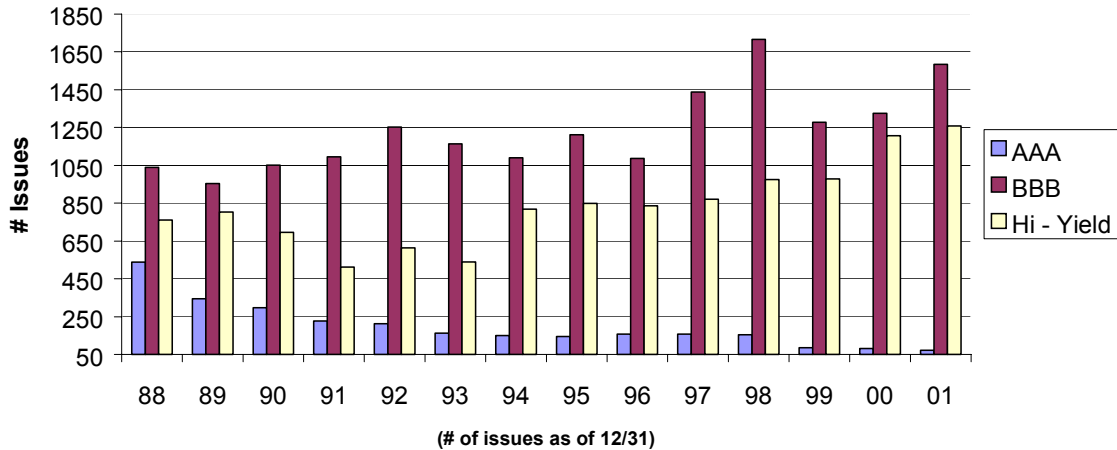
Quality Analysis of the Lehman Brothers Credit Index, 1973–January 31, 2002



According to this chart it is clear that high quality investment grade corporate bonds are a dying breed and that riskier Baa securities are becoming a dominant reality in the U.S. corporate bond market. In fact, the lower half (i.e. A-Baa rated) of the market now represents nearly 75% of the Lehman Credit Index up from only 42% less than three decades ago. Unfortunately, most investor's portfolio investment guidelines and restrictions have not come to grips with these facts. Indeed for those investors, who traditionally restricted themselves to the high quality sectors of the corporate market, they may now find that locating a diversified inventory of high quality corporate bond alternatives is 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 below, 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.

Historical Number of Issues



Source: Merrill Lynch & Co. Global Market Indices

In view of this trend, the coincidental rise in the number of issues used to create the Merrill Lynch BBB and High Yield Indexes should come as no surprise to investors. In fact, 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 investment 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 may 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 new market realities. In our view, most investor fixed income investment guidelines are woefully behind the times and not reflective of the new risks present in the U.S. bond market. The new risk dimensions represented in the bond market's structural changes and security availability are forcing investment managers to reorganize or significantly modify their traditional investment 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 risks as well as 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 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 they present.

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