

Investing In High Yield Bonds

By Bernard E. Scoville November 17, 2010

1. BARGAIN:

- A. First there is a prejudice against high yield bonds, which are called junk bonds.
- B. Secondly, there are laws and regulations against high yield bonds. Many institutions are only allowed to hold "investment grade" bonds
- C. For several reasons high yield bonds are cheaper than they would otherwise be.

2. DIVERSIFICATION:

I don't advocate investing only in high yield bonds. Having several high yield bonds is safer than only having one. Even having just an occasional high yield bond can boost portfolio return.

3. OUTPERFORMANCE:

Michael Milken first got me interested in high yield bonds. He documented how a basket of high yield bonds over time outperformed a basket of investment grade bonds, even though some high yield bonds defaulted. I have contacted the Milken Institute for related information.

4. DEFAULT NO BIG DEAL:

- A. The rate of default varies, but it usually is about 5% a year. Few high yield bonds default.
- B. When bonds default, you get on average about 36% of what you were supposed to get. With a bond you have seniority.

5. COMPANY IMPORTANT:

With a high yield bond, the underlying company is very important. It should not go broke. I spend a lot of time looking at the common stocks of my high yield bonds.

Five tools I use to evaluate common stocks are Yahoo Finance (<http://finance.yahoo.com/>), Better Investing's (<http://www.betterinvesting.org/public/default.htm>) Toolkit software, and the company Investment Relations Department. I also use some liquidity and solvency ratios I learned in accounting.

- A. Yahoo Finance gives me all kinds of information including insider transactions. I love companies with insider buying. This has worked well for me.
- B. I am a lifetime member of Better Investing. Better Investing's Toolkit software let's me visualize the history of a company's sales, pretax profits, and earnings. It also gives many other insights into the common shares. I am bringing a sample Toolkit report of MXT, a high yield bond that I now hold. Note that at least the sales continue strong.
- C. I like to look at a company's website and contact its investment relations department for information.
- D. I like doing some liquidity ratios to evaluate my bonds:
 - I. Current Ratio: (current assets/current liabilities. $1013/1424$ (0.71) for Realogy – weak. (In a few paragraphs, I buy Realogy bonds.)
 - II. Current cash debt coverage ratio: (cash from operations/average current liabilities). $1052/((1424+1440)/2)$ (0.73) for Realogy – weak.
- E. I like doing some solvency ratios to evaluate my bonds:
 - I. Debt to total assets ratio: (total liabilities/total assets). $9.143/8.162$ (1.12) for Realogy – weak.
 - II. Cash debt coverage ratio: (cash from operations/average total liabilities) $1052/((9143+9022)/2)$ (0.12) for Realogy – weak.

5. ACTUALLY SELECTING A HIGH YIELD BOND:

In selecting a high yield bond, I prefer Fidelity. They let me see all their bond listings, including high yield bonds. At TD Ameritrade a bond broker told me, when I called because I could not see high yield bond listings, that TD Ameritrade does not make junk bond listings available to its customers. I think the same is true at Schwab. However, if you know CUSIP, you can order high yield bonds at any of these brokers.

At Fidelity (<https://www.fidelity.com/>), after logging in or not logging in, click on the "Research" Tab. Then I select "fixed income". Next select "over 20,000 individual bonds". Here I select "Non Investment Grade/High Yield (Secondary)".

I next put in values like these:

Minimum Maturity Date: "12/2012"
 Maximum Maturity Date:: "12/2090"

Tier: "1 " Other: checked.

Moody's Minimum Rating: "C" Moody's Maximum Rating:"B1"

S&P's Minimum Rating: "C" S&P's Maximum Rating:"B"

Call Protection: "All"

Continuous Call Protectiuon: "All"

Select: Table Display.

Sinking Fund Protection: "All"

I am very inclusive, when I start. I can reject bonds later.

When I submitted this request, it returned 38 bonds. I then clicked on "Yield/Bid/Ask" to sort these bond by yield to maturity. Here were the top 4 bonds:

NewPage Corp	– Yield 52.6%	
REALOGY CORP Private	– Yield 17.0%	CUSIP: 75605EAW0
Dynegy Incorporated (DYN)	– Yield 13.8%	
Rlte Aide Corp (RAD)	– Yield 11.5%	

I couldn't find out about NewPage, but I did request an investor kit from them. I didn't like DYN and RAD; these companies seemed weak to me. REALOGY is intermittently earning money and has other positive attributes. I subscribed to their investor information and ordered 10 REALOGY CORP CUSIP: 75605EAW0 bonds.

I saved my search. Next time I can do it easier. I also imported my search into a spread sheet. The above search is somewhat fictitious; I experimented and searched several times, but the above search illustrates the results you can expect.

If I struck out I could have bought JNK, a high yield ETF, now yielding 10.8%. Easy way to invest in high yield debt with diversification.

When I saw bonds that I liked, I called the Fidelity Fixed Income Department or checked the box to the left of the desired bond and clicked on "trade" at the right of the page.

6. MAINTENANCE:

As Jim Cramer says, you can't buy and hold, you have to buy and do homework.

FINRA (Financial Industry Regulatory Authority) is the largest independent regulator for all securities firms doing business in the United States. I watch all my holdings in Finra's (<http://www.finra.org/>) Watchlist, which can be reached through their Market Data page. I can put in bond CUSIP numbers so that I can see current prices and yields to maturity. I sort the bonds by clicking on "Yield" on the far right of the page. This sorts most of them by yield to maturity. Finra does not give the yield to maturity on some bonds. I believe these are bonds that have been taken over by other companies.

Yield to Maturity is the best measure of bond return. It considers both the interest payments and the principal payment. I like 10% or more. More is better for me, most of the time. When high yield bonds recover and have 6% or less yield to maturity, I sell them.

From time to time I reevaluate my companies and their bonds using the five tools I have indicated plus other tools – listening to and reading financial news, talking with friends, etcetera.

Reference:

High Yield Bonds: Market Structure, Portfolio Management, and Credit Risk Modeling. Edited by Theodore M. Barnhill, Jr, Milliam F. Maxwell, and Mark R. Shenkman. McGraw Hill, 1999.