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High-yield bonds - it's all about intrinsic value

Despite the broad-based improvement of the financial markets since mid-March, there is still no clear trend in sight. Investors are at a loss when it comes to deciding which asset class currently offers the best potential. The financial crisis that has sent waves of turbulence rippling through markets worldwide has also impacted the performance of those bonds categorized as 'high-yield'. Their low correlation to other asset classes has earned high-yield bonds a place as the instrument of choice for portfolio risk optimisation among return and security-oriented investors. Average returns of ten percent or more were still possible from this asset class in 2006, whereas the average in 2007 barely reached three percent. However, the market has disproportionately penalized many companies during this latest crisis, sending the values of their bonds too far downward. This has opened up some very attractive opportunities for investors to profit from investment in the right companies. In the high-yield market, Value Investing is the key to successful bond picking.

Generally speaking, high-yield bonds can significantly improve portfolio performance without a considerable increase in risk - if one invests wisely. The most important factor is "intrinsic" value, or the actual value of the company issuing the bond. Every high-yield bond has a limited upside potential coupled with a risk of 100 percent default. The insolvency of a single company and a total default on its bond can have a drastic impact on the overall performance of a high-yield bond fund. Thus, the right strategy is not to find the "best" bonds, but rather to avoid the "worst". Even though Value and Growth issues compete with each other atop the performance lists in the short and medium terms: *the long-term performance of a share reflects the intrinsic value of the company*. This principle holds true not only for equities, but for bonds as well. A linking of the Value approach with the return potential specific to high-yield bonds can optimise the risk-return profile of high-yield funds.

In the current market environment, it is particularly interesting and important for investors to note that the value of *European* high-yield bonds suffered markedly larger declines in the financial crisis than did their US counterparts. Numerous European companies with excellent balance sheets are being traded at a serious discount - meaning that they are attractively valued and offer a great deal of upside potential. Moreover, the best conditions for returns on high yield bonds are: a slightly climbing market with stagnant or slowly advancing interest rates - which is precisely what we are now seeing, especially in Europe. Though the largest and best-developed high-yield market is the United States, the European market has come into its own and grown more diverse over the past several years. It now covers nearly every sector, which is important for broader risk diversification in the high-yield segment.

For anyone wanting to take advantage of the opportunities offered by the current undervaluations in the high-yield bond market, the time to get in is now. Investors with a long horizon can find an attractive investment opportunity in high-yield funds managed based on a Value approach. Instead of pursuing the highest coupon - with an equally high risk of default - these funds focus on good long-term performance at the lowest possible level of risk. This is a strategy that will pay off for investors in the long run.