At the start of 2000, at the same time the stock market bubble burst, returns of junk bond funds began to slump and continued their dismal performance through 2002. Recent one-year returns, however, averaged 20%, again tracking the stock market rebound. The question naturally arises: Is now a good time for individuals to invest in this sector?

The term “junk bonds” actually dates back to the 1920s, when it was used by traders to designate bonds of companies that suddenly found themselves in financial difficulty. These companies were also called “fallen angels.”

At the current time, the term “junk bonds” encompasses a more diverse group of corporations than just fallen angels. It designates corporate bonds of any corporation rated below investment grade. Because the term “junk” is somewhat blunt, a large number of euphemisms are also used to designate the same bonds: They are also called “high yield,” “high income,” “non-investment grade,” “speculative,” or even “high opportunity” debt. I prefer the term “junk” because it is straightforward and unambiguous.

What sets junk bonds apart from other types of bonds is that, while junk bonds are fixed-income instruments, the primary risk factor is not interest rate risk but rather the risk that the company that issues the bonds may not survive. As a result, junk bonds tend to do poorly if the economy is in a slump, and perform better when the economy strengthens. Correlation of junk bond returns is somewhat higher with the stock market than with the bond market. But junk bonds are volatile and unpredictable securities.

Most individual investors invest in this sector of the bond market through bond mutual funds. When I wrote the second edition of “The Bond Book,” at the end of 1999, junk bond funds were highly popular. Approximately 35% of all the monies in taxable bond funds were in junk bond funds. At the time, moreover, average annual compound returns for the group were higher than those of any other sector of the bond fund universe for both the 20-year and the 10-year periods ending December 31, 1999.

At the start of 2000 (at the same time the stock market bubble burst), returns of junk bond funds began to slump and they continued to be miserable through most of 2002. Assets departed from junk bond funds, so that at the current time, junk bond funds comprise only about 15% of assets in taxable bond funds. But as this article is being written (in August of 2003), according to Lipper Inc., total returns for bond funds investing primarily in junk bonds averaged approximately 20% for the one-year period ending July 31, 2003, again tracking the stock market rebound. So the question naturally arises: Is now still a good time to invest in this sector of the bond market? For some perspective on this question, let us first look briefly at a history of the sector, and then at junk bond funds.

A BRIEF HISTORY

Junk bonds are not all equally risky. There are five ratings below invest-
ment grade, as shown in Table 1. These ratings designate bonds of companies that are in some degree of financial difficulty, ranging from somewhat speculative to outright default.

Junk bonds (and therefore, bond funds that invest in junk bonds) are unique because risk is almost entirely related to credit quality. Bonds in this credit category are typically issued with maturities in the five-to-ten-year range so that interest rate risk is relatively modest.

Up until the 1980s, this was a rather obscure and limited corner of the market, the province of a small number of specialists. The junk bond fund sector expanded dramatically in the mid-1980s. This was partly due to the activities of Mike Milken, of Drexel Burnham Lambert, who created a new type of junk bond, issued to finance merger and acquisitions activity, including hostile takeovers and leveraged buyouts. These bonds received a huge amount of publicity. But the market’s expansion was also due to the entrance of entirely new customers. A number of mutual funds were established, which attracted significant demand from individual investors. Institutions, including banks (mainly thrifts) and insurance companies, also flocked to buy junk bonds.

The attraction of these bonds was, of course, their high yields. The difference in yield between Treasuries and lower-rated bonds is known as the “spread.” The lower the credit quality of any bond compared to Treasuries, the higher the spread. These junk bonds sold at yields that were as much as 400 or 500 basis points higher than Treasuries with similar maturities. A body of thought developed among institutional investors and academics that a portfolio of junk bonds would ultimately provide higher returns than a portfolio made up primarily of higher-quality bonds. The reasoning was that, even in spite of potentially high default rates, the higher interest income would eventually result in higher total return than for more highly rated bonds. But as astute investors might have predicted, rising demand for junk bonds eventually resulted in lower yields. The spread between junk bonds and Treasuries narrowed to about 200 basis points. In 1989 and 1990, junk bonds began to plummet in value. Declines were horrendous.

When spreads between junk and Treasuries widened to about 700 basis points, some investors saw this as a compelling buying opportunity. Junk bonds (and junk bond funds) rallied briefly, only to decline in value again as the fear of an approaching recession spread. This time, the declines in price were even more horrendous.

In November 1990, spreads between junk and Treasuries reached an amazing 1,100 basis points. It is not an exaggeration to say that the selling of junk bonds during 1989 and 1990 reached panic proportions. At the height of the panic, junk bonds were being sold for 30 to 40 cents on the dollar, with yields-to-maturity ranging from 20% to 40%. These extraordinary declines were due to a number of factors. Hanging over the market was a major liquidity crunch, which began with the exit of Drexel Burnham Lambert, Inc., the primary market maker in the junk bond sector, from this market. Suddenly, the junk bond market seemed to have only sellers and no buyers. In addition, individual investors were bailing out of junk bond funds and forcing these funds to sell into the already illiquid market. Even worse, government regulators ordered thrifts and banks to get rid of any junk bonds they owned. Finally, default rates on junk bonds reached 5.6% in 1989 and 7% in 1990. There was increasing worry that default rates would go even higher if a recession occurred.

The panic was overdone. In early 1991, a strong rally ensued. During the decade of the 1990s through the present time, junk bonds have gone on several similar roller coaster rides. Severe declines occurred twice: during the economic crisis of 1998, particularly after Russia defaulted on its debt; and during the recent recession. During 2002, yield spreads between junk bonds and Treasuries again widened to close to 1,000 basis points. But once again, this proved an attractive time to invest.

Since the mid-1980s, the junk bond sector has undergone many changes. Approximately 20% of all corporate debt in the U.S. is rated as “junk” and—somewhat surprisingly, in spite of continual changes in the economy—that percentage has remained relatively constant.

Merger and acquisition activity ceased to be a major factor in the early 1990s. During the 1990s, prominent issuers of junk bonds included telecoms as well as start-up companies too weak financially to be rated investment grade, but

### Table 1. Junk Bond Ratings and What They Mean

<table>
<thead>
<tr>
<th>Moody’s</th>
<th>S&amp;P</th>
<th>Fitch</th>
<th>What They Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ba</td>
<td>BB</td>
<td>BB</td>
<td>Somewhat speculative; low grade</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
<td>B</td>
<td>Very speculative</td>
</tr>
<tr>
<td>Caa</td>
<td>CCC</td>
<td>CCC</td>
<td>Even more speculative; substantial risk</td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
<td>CC</td>
<td>Wildly speculative; may be in default</td>
</tr>
<tr>
<td>C</td>
<td>C</td>
<td>C</td>
<td>In default</td>
</tr>
</tbody>
</table>

Junk Funds (High Current Yield)  

<table>
<thead>
<tr>
<th></th>
<th>1 Mo (%)</th>
<th>3 Mos (%)</th>
<th>1 Yr (%)</th>
<th>5 Yrs (%)</th>
<th>10 Yrs (%)</th>
<th>20 Yrs (%)</th>
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</thead>
<tbody>
<tr>
<td>Junk Funds</td>
<td>-0.99</td>
<td>2.56</td>
<td>20.41</td>
<td>0.40</td>
<td>4.65</td>
<td>7.97</td>
</tr>
</tbody>
</table>

Source: Lipper Inc.

The question may appear silly, but it is not. Many “junk” bond funds—those that are rated below investment grade, as defined earlier—are considered junk bond funds. In contrast, bond funds with high-quality credits are not considered junk funds. The primary risk is the risk of default, which is high because risk of default is high.

To add to the confusion, some bond funds that have the term “high yield” or “high income” as part of their name. For example, junk bond funds with the words “high yield” as part of their name. Bear in mind, also, that those are total returns, which means that the high dividend yields quoted by junk bond funds are included in the returns! The striking fact is that, for that five-year period, total returns of junk bond funds lagged well behind those of the other, far more conservative bond funds listed in the same table; in fact, they even lagged those of riskless money market funds.

The comparison of total returns of junk bond funds and more conservatively managed bond funds improves for the 10- and 20-year periods ending July 31, 2003, although those returns still lag those of the other sectors. This is a major contrast to the 10- and 20-year periods ending December 31, 1999 (alluded to earlier), when total returns of junk bond funds were higher than those of any other bond funds. Whether future returns of junk bond funds will continue to lag or once again surpass those of other sectors cannot be predicted.

Table 2 shows average total returns for junk bond funds for various time periods through July 31, 2003. For comparison, I have included returns of less risky fixed-income sectors, such as intermediate taxable government bond funds and GNMA bond funds, and riskless money market funds.

Table 2 also illustrates the fact that high yield does not always result in high total return. While quoted yields for junk bond funds are always higher than those of any other type of bond fund, swings in the net asset value of junk funds result in high volatility. Periods of...
good returns alternate with periods of miserable returns, and each can last a long time.

Losses in this sector can be very high. In 1989 and 1990, some funds lost as much as 50% of their total value within a period of one year, and 70% of their total value within a two-year period. This means that an investment worth $10,000 at the beginning of 1988 would have shrunk to approximately $2,500 at the end of 1990, even after adding back the dividends. A number of funds simply went out of business. Some funds merged with other funds or changed their names. Very high losses also occurred during the last four years.

A seldom-noted factor contributing to losses in junk bond funds is the erosion of principal value that results from defaults. When a default occurs, the value of a bond does not go to zero because company assets are sold and the proceeds are disbursed to bond holders. Nonetheless, there will be some loss, and a consequent decline in net asset value. As the net asset value shrinks, even if the published yield does not change, the monthly payout will shrink because it is based on a diminished portfolio. Theoretically, over time, the high dividend yield of junk bond funds may compensate for some of these defaults. But if default rates spike, or if a bond fund is managed very aggressively, then the losses can be much higher, and more devastating.

You can expect that any bond fund investing in junk bonds will experience some actual defaults. But because the riskiness of junk bonds varies from somewhat speculative to companies in outright default, bond funds investing in this sector of the market differ from each other in the degree of riskiness they exhibit. The more aggressive funds invest in the riskiest bonds; more conservatively managed funds stick to less risky bonds.

This is a group of funds where returns vary widely from fund to fund. When junk bonds prosper, aggressive funds tend to have the highest returns. But when returns are poor, aggressive funds experience the most disastrous losses. Erosion of principal also tends to be very high in the more aggressive funds. More conservatively managed funds, particularly if they are no-load and have low expense ratios, tend to be somewhat less volatile and somewhat more consistent in their performance.

Table 3 illustrates average total returns for the best- and worst-performing “junk” bond funds for a variety of periods ending July 31, 2003, as well as average performance for the entire sector.

Bear in mind that when you are looking at tables of average annual total returns for long periods (say five or 10 years), particularly after a period of very high returns, good returns for one year raise compounded returns for the entire period. They therefore mask volatility of returns from year to year. Over very long holding periods (exceeding 10 years), conservatively managed “junk funds” generally have positive total returns because the high dividend yields, compounded year after year, provide a cushion for fluctuating net asset values. But funds that are managed very aggressively may experience such enormous losses that they do not come back.

**TO BUY OR NOT TO BUY?**

The main argument in favor of holding junk bond funds is that they provide diversification for a large portfolio because returns do not correlate precisely with other sectors of the bond market, such as Treasuries or GNMAs.

Table 2 provides a good example of this point. As the economy went into a slump early in 2000, interest rates fell and investment-grade bonds did very well, whereas junk bonds had miserable returns. During the last few months, as perceptions grew that the economy was improving, interest rates rose sharply and investment-grade bonds slumped, whereas junk bond fund returns were stellar. This is not an uncommon pattern. Accordingly, proponents of junk bonds argue that junk bonds lower the total risk of a portfolio because their returns do not move precisely in tandem with other interest rates.

That argument, however, is mainly relevant for very large, well-diversified portfolios, such as those of an insurance company or a pension fund. The fact that investment-grade bonds and junk bonds do not move in lockstep helps these large institutions to meet their annual liabilities. And in fact the current buyers of junk bonds are primarily large institutions.

Most individual investors do not have the same needs. And periods of decline such as those that occurred in 1989 and 1990, as well as for the period between 1998 and 2002, can be devastating.

In addition, proponents argue that in spite of higher default rates, the
spread between the total return of junk bonds and investment-grade debt is large enough to compensate investors for their risk. Ultimately, the higher interest income, particularly when reinvested and compounded over long holding periods, results in higher returns than investment-grade debt. But again, as shown in Table 2, that is by no means certain.

Here are some thoughts to consider when trying to decide whether or not to invest in junk bonds.

Should you invest in junk bond funds if you are investing primarily for income?
If you listen to radio talk shows, you might think junk bond funds are appropriate vehicles for individual investors who need a source of high income.

That is emphatically not my view. If you cannot afford a significant loss, and if you need a source of steady income, then junk bond funds are not for you. Potential loss of principal is too high, and total returns too unpredictable.

Suppose you have a large and very well diversified bond portfolio, and you want to invest in junk bonds—should you buy a fund or individual bonds?
Because of the imperative need to diversify, and the genuine expertise required to analyze individual “junk” bonds, mutual funds represent the most practical way for the average individual to invest in junk bonds. The diversification inherent in any bond fund affords some measure of protection against the inevitable defaults. But then, you need to investigate carefully the history and the management style of the fund to make sure that the fund matches your objective. Note that, in order to discourage “hot” money from going in and out of “junk” funds for very short periods of time, a number of no-load fund groups charge a 1% fee if you redeem shares held for less than one year. During the panic years of the early 1990s, some mutual fund groups adopted the policy of routinely advising potential investors that junk bond funds were speculative, and a number have continued that policy.

What if you own one or more junk bond funds and are wondering whether to hold or sell?
Trying to time any market is extremely difficult, and junk bonds are no exception. But clearly, one key to the performance of junk bond funds is the spread of junk to 10-year Treasuries. When the spread is wide, even though that coincides with a period when no one wants to own junk, that is the time to buy. As in any sector of the market, you want to buy low, sell high. When the spread is narrow—again, even though that tends to be a time when junk is popular—you have to ask yourself if you are being compensated for the very high risk of owning junk bonds.

Exact timing, however, is not possible because periods of narrow or wide spreads can last for years. Historically, the spread has varied from a low of about 200 basis points to a high of about 1,100 basis points. In the fall of 2002, the spread of junk to 10-year Treasuries reached approximately 1,000 basis points. At the current time (August 2003), it has narrowed to approximately 475 basis points. Much of the gain in junk funds over the past year is due to a rise in net asset values as spreads have narrowed. Clearly, the easy money has been made.

On the other hand, the spread is still fairly wide by historical standards. If the economy recovers—or at least does not get worse—then junk bond funds may continue to perform reasonably well. If the economy goes into a downturn, or if interest rates continue to rise, then, the net asset values of junk funds may head south.

IN SUMMARY
What’s the bottom line on junk bonds?
• If you are investing in bonds for the safe, predictable part of your portfolio, or primarily for income, then you should view junk bonds as speculative and not worth the risk.
• If you have a large, highly diversified bond portfolio (well in excess of $300,000), and you can sustain large losses in assets that you will not need for a long period of time, then you may want to consider junk bonds—but for no more than 20% of your portfolio.
• Because of the imperative need to diversify, and the high degree of expertise that is required to analyze junk bonds, bond funds represent the most practical way for individual investors to invest in junk bonds.
• Be sure to investigate the history and the management style of any junk bond fund before investing any money.