



## Corporate Bonds: Are they the New Stocks?

*A BNY Mellon Asset Management  
Roundtable Discussion*

The recent financial crisis has produced a mass migration from “risky assets” to “safety assets.” Risky assets (stocks, corporate bonds, commodities, etc.) were sold indiscriminately while safety assets (mainly government bonds) were bought indiscriminately.

Many people have said that “diversification failed: in a crisis all correlations go to 1.” This is only half true. *Partial* diversification failed: the correlations among risky assets approached 1 as investors fled risk. *Total* diversification worked: the correlation between risky assets and safety assets approached -1 as investors sold the former and bought the latter. Unfortunately, total diversification was rare, thanks to a multi-decade bull market that taught investors to have minimal exposure to safety assets.

In a “normal” investment environment, corporate bonds fall midway on the risk/return spectrum between risky assets and safety assets. Investment grade corporates are closer to government bonds, while high yield corporates are closer to equity. In the recent environment, even investment grade bonds were viewed as quasi-equity and sold off sharply. This has led many commentators to conclude that corporate bonds now present a unique investment opportunity, offering equity-like returns with below-equity risk.

To address the stock/bond question, we organized a conversation among investment professionals representing three of BNY Mellon Asset Management’s investment boutiques:

- **Kent J. Wosepka**, Chief Investment Officer of Active Fixed Income at **Standish**, which specializes in active fixed income strategies.
- **Ralph Goldsticker**, Managing Director of Strategic Investments at **Mellon Capital Management Corp.**, which specializes in global tactical asset allocation and a range of other disciplined, analytical global systematic strategies.
- **John Truschel**, Chief Investment Officer of **The Boston Company Asset Management (TBCAM)**, which is dedicated to active, fundamental equity management.

**Bob Jaeger**, Senior Market Strategist of BNY Mellon Asset Management, moderated the discussion.

As the conversation evolved into this special report, we decided to let each boutique take responsibility for a distinct point of view. Standish makes the case for bonds, MCM makes the case for stocks, and TBCAM emphasizes the importance of investor-specific factors (economic outlook, time horizon, and so forth) and liquidity issues.

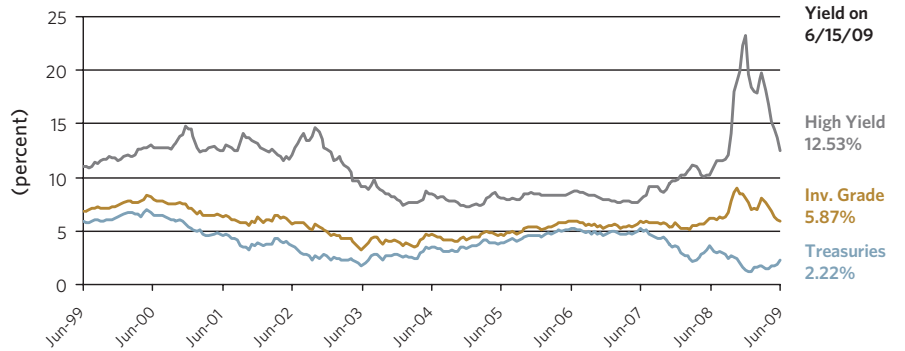
Recently, the mood of the markets improved dramatically. Equities and corporates both rallied as investors began to sense that “the worst is behind us.” But the optimism could vanish as suddenly as it appeared, and the basic contours of the relative valuation question are unchanged even though both markets appear to be less cheap than they were.

## Market Background - Robert Jaeger, BNY Mellon Asset Management

Exhibits 1 through 5 tell the basic story: low government bond yields, wide credit spreads, low stock prices, and high equity earnings yield. Exhibit 1 shows that corporate bond yields have spiked sharply after several years of unusually low yields.

Since mid-2007, corporate bond yields have spiked sharply, and spreads have widened dramatically relative to Treasuries.

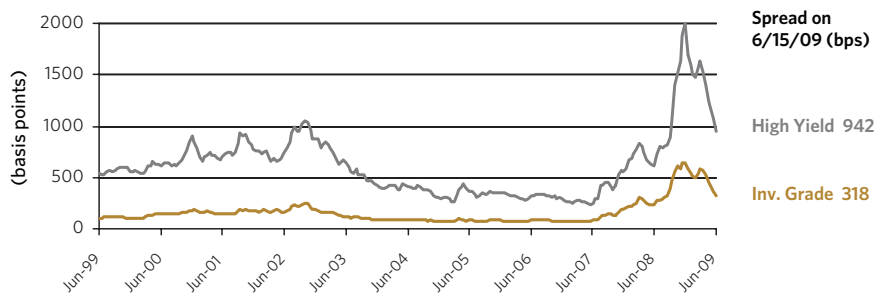
**Exhibit 1 — Bond Yields (10 Years Ended 6/15/09)**



Source: Barclays Capital Indexes and Thomson Datastream as of 6/15/09. See index disclosure on last page.

Exhibit 2 shows yield spreads relative to Treasuries. Since Treasury yields are now so low, the recent spike in yield spreads is much more dramatic than the spike in nominal yields. Even though spreads are off the peaks reached in the depths of the financial crisis, they are still at very high levels.

**Exhibit 2 — Bond Spreads (10 Years Ended 6/15/09)**

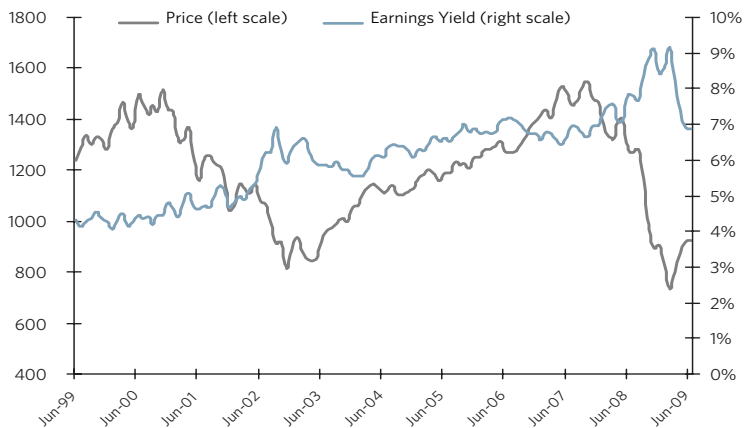


Source: Barclays Capital Indexes and Thomson Datastream as of 6/15/09. See index disclosure on last page.

As for the stock market, Exhibit 3 shows stock prices and earnings yield. (We invert the more familiar price/earnings ratio in order to facilitate the comparison with bond yields.) The earnings yield figure is based on consensus earnings estimates reported by IBES, not trailing earnings. Although earnings yield is off its recent peak, it is still at an abnormally high level.

During the sharp stock market sell-off, prices dropped faster than earnings expectations. Stock prices also touched new lows in March, while corporate bonds bottomed out last November.

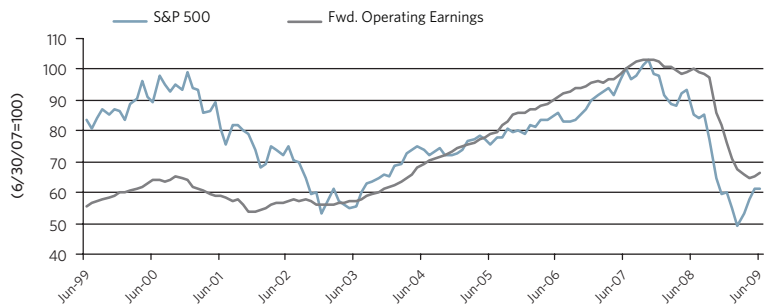
**Exhibit 3 — S&P 500 (10 Years Ended 6/15/09)**



Source: Thomson Datastream and IBES, as of 6/15/09. See index disclosure on last page

The explanation is seen in Exhibit 4, which shows that stock prices have fallen much more sharply than earnings expectations. When P falls faster than E, E/P goes up.

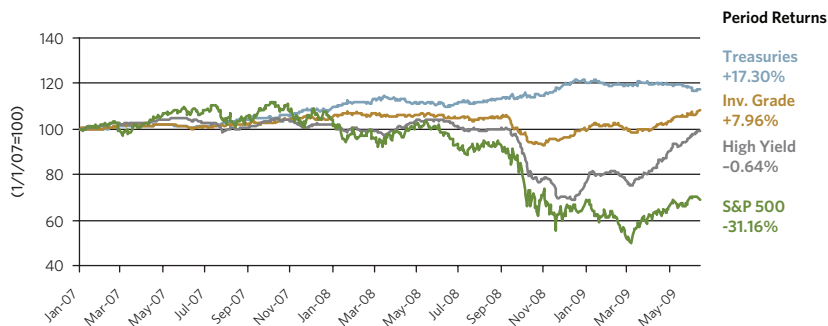
**Exhibit 4 — S&P 500 and Operating Earnings (10 Years Ended 6/15/09)**



Source: Thomson Datastream and IBES, as of 6/15/09. See index disclosure on last page.

Finally, Exhibit 5 shows a close-up of market action since the beginning of 2007. To facilitate the stock/bond comparison, we use total returns, not yields, for all four asset classes. Notice the difference between November 2008 and March 2009: the stock market pierced the November lows in March, but the credit market did not.

**Exhibit 5 — Total Returns (1/1/07 - 6/15/09)**



Source: Barclays Capital Indexes and Thomson Datastream as of 6/15/09. See index disclosure on last page.

Given the extraordinary current environment, what should an investor do? Are the high yields in the credit markets a better choice than the potential gains in a beaten-up stock market? We start with Kent's perspective on these questions.

### The Case for Corporate Bonds – Kent Wosepka, Standish

The case for corporate bonds is straightforward. They offer yields equal to or greater than long-term equity returns, they are currently dirt cheap, and they should have less downside than stocks.

At Standish, we are optimistic but quite cautious on the economy and the financial markets. To us, a quick recovery to conditions BSP (“before sub-prime”) does not seem very realistic. While the decline in many economic indicators has slowed recently, saying that the economy is no longer in freefall is much different than a forecast of rapid growth. Data is still almost universally horrible, with the economy still on the ropes. For example:

- More than half a million jobs have been lost per month.
- Measured year-over-year, the economy is currently experiencing deflation.
- New home sales are at less than one-third the rate of just three years ago.

Our base case scenario is that the economy stabilizes over the next few quarters, but that the recovery will not feel much different from the recession. We believe the rate of labor unemployment will remain high for a prolonged period of time. When you combine high unemployment with massive excess capacity in manufacturing, deflation is more of a concern than incipient inflation.

With this backdrop, and based on historical data, the case for corporate bonds is straightforward. They offer yields equal to or greater than long-term equity returns, they are currently dirt cheap, and they should have less downside than stocks. Therefore, in the event of improved financial conditions, corporate bonds generally should recover before stocks, since recovery begins at the top of the capital structure.

Investment grade corporate bonds trade at yields-to-maturity that imply default rates nearly twice those seen during the Great Depression. Yields to maturity on high yield bonds imply even more drastic scenarios. If we are right in thinking that a strong economic recovery lies well in the future, then investors in high yield and investment grade corporate bonds will be paid to wait.

To put the relative values of corporate debt and equity in perspective, consider the fundamentals of capital market pricing. Equity is lower on a company's capital structure than debt, thus the long-term expected return for equity should be greater than that of corporate bonds to compensate investors for the greater risk and volatility. Periodically, idiosyncratic shocks – like the liquidity shock of 2008 – can push corporate bond values down to a point where the typical capital structure pricing relationship is violated. This presents the situation where, in our opinion, the forward looking expected return on debt is greater than that of equity. Therefore, if you believe (as we do) that the normal pricing relationships will eventually reassert themselves, equity prices must fall (or not rise as much) when compared with corporate bond prices.

The major risk for corporate bond holders is, of course, default. According to Moody's, which maintains default data back to 1920, the worst 10-year annualized default rate for all corporate bonds – including both high yield and investment grade – was 3.5%. This occurred during the 10 years of the

The top arguments for corporate bonds, relative to stocks, are: yields near or in excess of historical equity returns, the relative safety of a senior position in a company's capital structure, and better recovery prospects in the event of default.

Great Depression, ending officially in 1938. In 2008, by contrast, the default rate for investment grade corporate bonds was 0.40% while high yield was 3.55%. In the event of default, senior bond recovery is almost always greater than zero.<sup>1</sup>

Over the past 25 years, the average recovery on defaulted corporate debt has been 43 cents on the dollar. If we assume recovery rates will be much lower than average, say 30 cents on the dollar, current yield spreads imply a 10-year annualized default rate of over 7% for investment grade credit and over 21% for high yield. Remember that 3.5% is the worst 10-year annualized default rate for *all* corporate bonds, ever.

We certainly have no monopoly on asset price forecasts, but from our vantage point, corporate bonds offer as attractive a risk/return trade-off as we have ever seen. The top arguments are: yields near or in excess of historical equity returns, the relative safety of a senior position in a company's capital structure, and better recovery prospects in the event of default.

Corporate bonds also offer a large illiquidity premium. Corporates are always less liquid than Treasuries, and now they are even less liquid than usual. Bid/offer spreads are wide, and in some cases there are no bids or offers at all. Potential sellers don't want to sell at what they regard as low prices, and many potential buyers don't have the cash with which to buy. Indeed, corporates are now substantially less liquid than equities, but at this point we are being very well compensated for the illiquidity.

Our econometric fair value models for investment grade credit currently suggest that credit spreads are about 125 basis points wider than they should be given all the "fundamentals." We think this residual is due to the decline in trading liquidity. If you know you are going to have a harder time selling an asset, you will demand a lower price (higher expected return) to buy that asset. The 125 "extra" basis points are compensation for illiquidity. If some modicum of liquidity returns to the corporate bond market, that liquidity premium should lessen, resulting in capital appreciation to corporate bonds. If you assume that a credit portfolio has a five year duration, then 125 basis points of spread narrowing creates 6.25 points of potential capital appreciation if/when liquidity improves. On the other hand, if liquidity does not improve, then we are paid an extra 125 basis points in yield over fair value to wait.

The negative to corporate bond prices comes when liquidity transitions from excellent to poor. Given that we are already deep into the "poor" stage, investors are being paid for assuming illiquidity risk. If liquidity were to return even simply to a "good" level, we would expect excess returns to accrue to corporate bonds.

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<sup>1</sup> All data in paragraph courtesy of Moody's Investors Service, 4/2009

## The Case for Stocks – Ralph Goldsticker, Mellon Capital Management

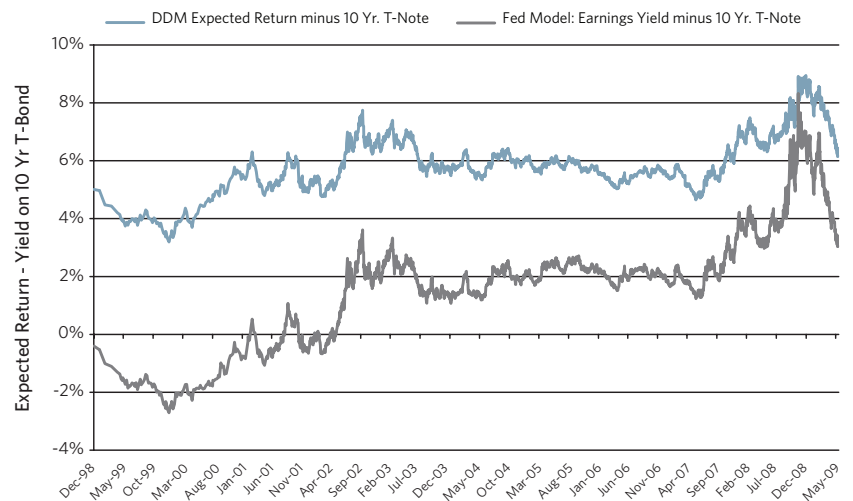
The broad argument for stocks is that prices are depressed because of elevated levels of risk aversion and uncertainty, and as a result are still below their fundamental value. We believe that this is still the case even though prices are well above their March lows. As the risks abate, and investors' risk aversion returns to more normal levels, our view is that stocks have more upside than bonds.

The broad argument for stocks is that prices are depressed because of elevated levels of risk aversion and uncertainty, and as a result are still below their fundamental value. We believe that this is still the case even though prices are well above their March lows. As the risks abate, and investors' risk aversion returns to more normal levels, our view is that stocks have more upside than bonds. As for timing when to enter the market, the stock market looks forward. As a result, we're not likely to see a bond recovery followed by an equity recovery. We think that the more likely scenario is that stocks would rally at the same time as bonds, or possibly even before.

Even the liquidity argument can be viewed in favor of stocks. The global flight to quality featured massive amounts of forced selling. Leveraged investors faced margin calls, and unleveraged investors often didn't have enough cash to meet spending commitments. When most other markets were frozen, the only assets that could be sold were government bonds and equities. When you are a forced seller you don't sell what you want to sell: you sell what you can. Since no one wanted to sell government bonds, they sold stocks. Looking forward, as liquidity returns to the markets, we anticipate seeing money flow into stocks as investors rebalance towards their desired asset mix. In addition, due to the recent relative poor performance of stocks, many institutional investors are underweight stocks, but have postponed rebalancing. As risk aversion abates, the normal rebalancing process will likely occur, which would also create flow from bonds to stocks.

At Mellon Capital, we evaluate assets by comparing prices to expected future cash flows. We monitor stocks' P/E ratios, dividend yields and other metrics, but for us the most important number is the "expected return" from Mellon Capital's proprietary dividend discount model (DDM). If you think about these metrics from the perspective of a bond manager, the earnings yield ratio is like the current yield, while expected return from our DDM is more like the yield to maturity. The strength of the DDM is that it is designed to incorporate the pattern of expected growth of corporate earnings into our valuation.

**Exhibit 6 — Valuation of S&P Relative to 10-Year T-Notes (1/1/99 - 6/15/09)**



Source: Thomson Datastream, IBES and Mellon Capital Management as of 6/15/09. See index disclosure on last page.

Our basic message is that fundamental relationships still apply. Earnings expectations have fallen a lot — in fact, much farther than in past recessions. But stock prices have fallen even farther, raising the expected return on stocks. At the same time, yields on Treasuries have fallen significantly, lowering their expected returns. As a result, in our view, stocks are very attractive relative to bonds.

Financial theory suggests that because equities are more risky than debt, they should offer a risk premium — higher expected returns than debt. When the forward looking risk premium is too narrow, stocks are expensive. As a result, their prices typically fall, raising their expected returns until the risk premium returns to a fair level. Conversely, when the risk premium is too wide, as is the case today, stock prices should increase. Both our U.S. and Global Tactical Asset Allocation Models incorporate this fair risk/return relationship in the asset allocation decision.

Exhibit 6 illustrates two views of the risk premium of the S&P 500. The lower line is similar to the frequently used “Fed Model.” It shows the spread between the 1-year forward earnings yield (based on IBES data) and the yield-to-maturity of 10-year Treasury notes. The upper line shows a similar relationship, but uses expected returns from MCM’s DDM rather than the stock market’s earnings yield. The upper line shows that between 2003 through the middle of 2007 the DDM-based risk premium fluctuated around 5 1/2%. However, since the third quarter of 2007, it widened to almost 9%. Recently it has fallen below 7 1/2%, but it is still well above its long-term average level. It is this excess risk premium that makes stocks so attractive to us.

The good news about stocks is that the bad news (unless one is forecasting a depression) is already priced in. In Exhibit 4, we see that forward looking earnings estimates of operating earnings for the S&P 500 are 35% lower than they were at the end of June 2007. This is consistent with a deep to severe recession. The revision downward from the peak is more than two times as large as what we observed in the 2001 recession. Until this cycle, that was the largest revision we had seen since the data began in 1984. (More good news is that the downward revisions seem to be over.) While earnings forecasts fell by 35%, at their lows stock prices were down 55%, and at the end of April are still down by more than 40%. As a result, whether measured using our DDM or earnings yield, the expected return of the stock market is higher than it was in June 2007.

Although corporate spreads are very wide, corporate bond investors may find that once spreads begin to narrow, the payoff is modest. The problem here is that Treasury yields are likely to rise as credit spreads narrow, which will mute the impact of narrowing spreads. As the flight to safety eases, we think that low Treasury yields will look increasingly unattractive, and many institutions that have deferred portfolio rebalancing can be expected to swap out of Treasuries into equities, putting upwards pressure on rates. Growth in inflation expectations is also likely to accompany an economy on the mend, which would put further upwards pressure on rates. Thus, the improving economic climate that strengthens companies would also tend to limit the capital appreciation on their bonds.

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## Risk Tolerance and the Liquidity Background – John Truschel, The Boston Company Asset Management

I agree with a great deal of what my colleagues have said, but the ultimate decision depends on your economic outlook and your risk tolerance. And your decision needs to take into account some important points related to liquidity.

The basics of the stock/bond decision are simple. If you have a positive economic outlook (i.e., better than consensus) and a long time horizon (which carries with it a high risk tolerance), then you should favor equities. If you're pessimistic on the economy and have a shorter time horizon, then corporate bonds are the better buy.

At TBCAM our business consists almost entirely of equity-only mandates, but we do manage the asset allocation for a small number of balanced accounts. We have been including both investment grade and high yield bond allocations in some of our balanced accounts, but not in our equity-benchmarked accounts. We are thus very sympathetic to Kent's case for bonds, but we are also very sensitive to the risk profile of the client.

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The decision gets harder when the two factors point in opposite directions:

- If you have a long time horizon but you're pessimistic on the economy, then you'll want to delay equity purchases until you become more optimistic about the economy. But the timing challenge is formidable. The stock market will likely turn before the economy turns, and may even turn before you develop the required level of economic optimism.
- If you have a short time horizon but you're optimistic on the economy, then you may want to be more aggressive in equities, but again you face the timing problem. The short time horizon means that you'll have no staying power if you invest too early. In general, investors are better at knowing their risk tolerances and time horizons than they are at forecasting the economy.

I agree with Kent's observation that "recovery begins at the top of the capital structure," but I also agree with Ralph's point that we aren't likely to see a bond recovery *followed by* an equity recovery. This may sound like a contradiction, but the point is simple: credit spreads need to narrow in order to heal "the real economy" and to set the stage for a durable equity recovery (which would involve both growth in earnings and a re-rating of earnings multiples). But the stock market will likely turn before the economy turns, and thus should turn before the fundamentals are in place for a longer-term recovery in equities. Indeed, the powerful rally of March/April 2009 may be a harbinger of that longer-term recovery. Or, it could be a bear market rally. That uncertainty has created a large "volatility premium" for equities.

This volatility premium is very different from the illiquidity premium that we see in the corporate bond market. As Kent pointed out, the depressed prices of corporate bonds reflect a substantial illiquidity premium. The stock market suffers from the opposite problem: it is not the lack of liquidity that is depressing prices, but the abundance of liquidity. The equity markets have absorbed massive amounts of forced selling throughout this financial crisis, yet forced sellers have met willing buyers. Equities have thus migrated *en masse* from weaker hands to stronger hands.

Although equities are liquid, their prices nonetheless reflect a very large volatility or “risk aversion” premium. If you buy a stock today, you can be reasonably sure that you will be able to sell it tomorrow. But if you are concerned that the price will be 5% lower tomorrow, then you’ll demand some sort of risk premium as compensation for “inventory risk.” Even after the equity rebound of March and April, investors are still very sensitive to the “open-ended downside” of equities, which is a significant depressant on prices.

Corporate bonds offer an illiquidity premium, stocks offer a volatility premium. Both are part of the relative valuation puzzle. Although corporate bonds offer a higher illiquidity premium than stocks, that does not automatically give them a higher expected return. When you take into account all the parts of the puzzle, it may well turn out that the more liquid asset has the higher expected return.

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I’d like to apply these thoughts to two very important parts of the institutional investment community: university endowments and defined-benefit pension plans. University endowments have become increasingly exposed over the years to a variety of illiquid assets: private equity, hedge funds, timberland, and so forth. This movement toward illiquidity is sometimes based on the idea that illiquid assets will generally produce a higher return than liquid assets. This generalization is not true: illiquidity is just one part of the picture. Moreover, illiquidity risk is like any other form of risk: sometimes you get paid for taking it, sometimes you don’t. The essence of risk is that you don’t know whether you’re going to get paid for taking it.

As for the defined-benefit pension plans, many of them have either implemented or have been exploring “liability-driven investing” (LDI), i.e., increasing the fixed income allocation in order to hedge the interest-rate sensitivity of the pension liabilities. Prior to the recent credit crisis, LDI was a very expensive choice: Treasury yields were low and credit spreads were tight. Now that corporate bonds are cheaper, one of the main obstacles to LDI has been removed.

However, the timing obstacle remains. Corporate bond prices are depressed, but so are stock prices. For most pension funds, implementing an LDI program involves swapping out of stocks into bonds. This creates a painful dilemma. If you sell stocks now to buy corporates, you lock in your losses on the equity side of your portfolio. If you “wait for stocks to come back,” and *then* swap into corporates, you’ll find that corporates aren’t a bargain anymore.

## Conclusion – Robert A. Jaeger, BNY Mellon Asset Management

If you can't deal with the volatility of equities, then the markets are offering you a unique opportunity: corporate credit is a very attractive alternative. If you can deal with the volatility, then switching into corporates creates the risk that you'll miss the eventual recovery in equities. For many equity-oriented investors, that risk is too much to bear.

Corporate bonds are cheaper than they've been for a long time, thus enabling them to offer potential returns that compare very favorably with the long-term return of equities. And that return is coupled with a very attractive risk profile. While the equity markets sometimes turn into bottomless pits of pessimism, the bond markets seem to have a "floor:" even if you make pessimistic assumptions about default rates and recovery values, you wind up with an attractive expected return.

The price of this comfort is that corporate bonds don't have the upside of equities. The "long-term return" of equities looks very pale when compared to the returns potentially available when equities are recovering from a unique combination of acute economic distress and pandemic forced selling. The explosive rally that began in March is the most recent reminder of this fact.

Although the mood of the markets has improved dramatically in the March/April period, the mood can change very quickly, and many investors have been traumatized by the recent history of the equity markets. If you can't deal with the volatility of equities, then the markets are offering you a unique opportunity: corporate credit is a very attractive alternative. If you can deal with the volatility, then switching into corporates creates the risk that you'll miss the eventual recovery in equities. For many equity-oriented investors, that risk is too much to bear.

If you can't stand the heat, then by all means you should get out of the kitchen. If you can stand the heat, then you probably won't be happy anywhere else.



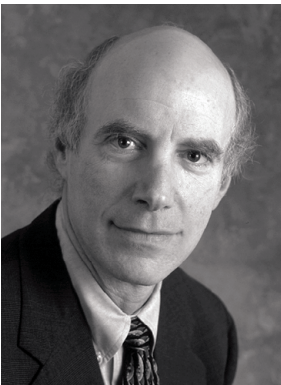
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Kent Wosepka,  
CFA

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Ralph Goldsticker,  
CFA

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John Truschel,  
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## Index Disclosure:

The Barclays Capital High Yield Index is an unmanaged index broadly representative of the U.S. high yield bond market. The Barclays Capital Investment Grade Index is an unmanaged index broadly representative of the U.S. investment grade bond market. The Barclays Capital U.S. Treasuries Intermediate Index is an unmanaged index broadly representative of the U.S. intermediate-term bond market. The Standard & Poor's 500 (S&P 500) Composite Stock Price Index is a widely accepted, unmanaged index of overall U.S. stock market performance. IBES is a prominent provider of earnings estimates, based on a proprietary database of about 45,000 companies in 70 markets.

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