GRANT'S
INTEREST RATE OBSERVER®
Vol. 02 No. 19b Two Wall Street, New York, New York 10005 • www.grantspub.com SEPTEMBER 24, 1984

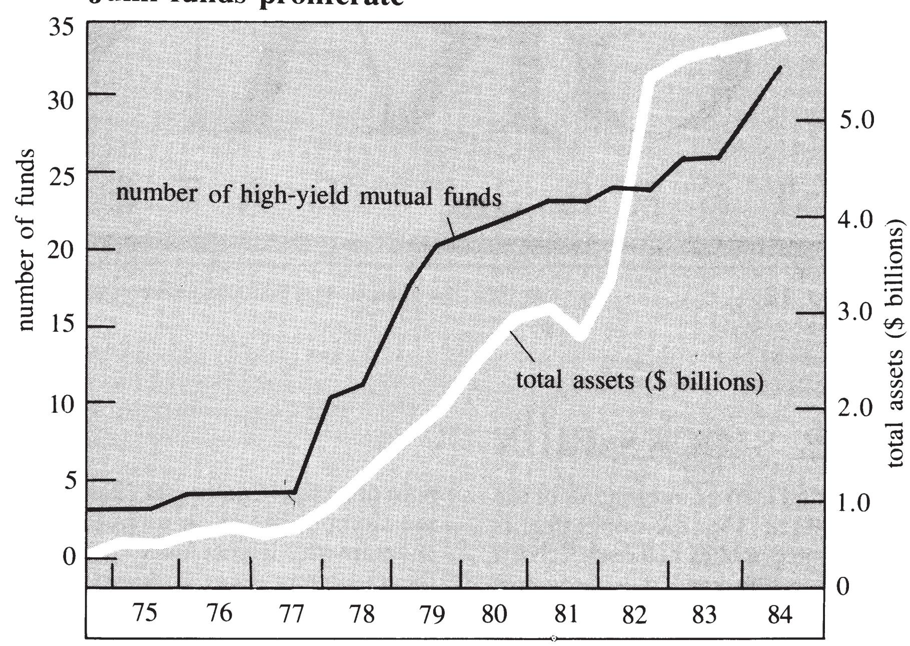
Junk debunked

"Payment of interest on a bond is fixed, and if not paid when due, failure is precipitated. Most corporation directors, no matter how successful the enterprise may be, hesitate to burden it with fixed charges, even if the future gives promise of earnings that exceed the charges many times over. And even in those instances when there seems no reasonable doubt but that the new money obtained from the sale of bonds will be invested so as to earn immediately, through new or improved equipment, more than sufficient to pay the charges, there is no assurance that this increased earning capacity will continue through the life of the bonds." —Arthur S. Dewing, *The Financial Policy of Corporations,* Volume IV, 1920

In the bond market, this is a day of high hopes and low interest-coverage ratios. It is a day of the near extinction of the triple-A corporate credit and the rise to investment respectability of the sub-Baa credit. It is a time that has nurtured the junk-bond movement and has taken to heart the junk-bond investment philosophy. As recently as a decade ago, only three "high-yield" corporate bond funds existed; their combined assets were $400 million. At last count, there were 32 such funds with assets running to $6 billion. In the mid-1970s, it was a rare speculative-grade new issue that was admitted to the public debt market; nowadays it's a rare triple-A issue that sees the light of day. (In fact, according to Salomon Brothers, no triple-A debt security has been sold this year, while the average monthly volume of Ba-or-lower merchandise is running just below the record pace set last year.) Merrill Lynch, describing the growth of the "high-yield" market, notes that there now are junk-minded insurance companies (it counts a dozen or so with a "major" commitment to speculative bonds), junk investment advisers and junk savings and loan associations. Not coincidentally, Drexel Burnham Lambert, the principal force in the junk market, is the fastest growing investment banking house in Wall Street.

To junk proponents, of course, all this is as it should be. Better to own the low-rated debt of an up-and-coming business, they say, than the investment-grade debt of the next International Harvester. They invoke Michael Milken, dean of junk at Drexel Burnam, who says: "Risk is a function of knowledge." In general, they say that the rating agencies are backward looking while markets exist to discount the future ("I'm much more interested in the future"—Milken). In credit analysis, they emphasize the significance of prospective growth in earnings and downplay the importance of historical balance-sheet ratios. They observe that the rate of default on corporate debt is vanishingly low, and they say that diversification will reduce such risk as may exist in one given portfolio. They recite the excellent junk investment record. "The total return to investors in high yield securities has been very impressive," writes the corporate-bond research unit at Merrill. "An invest-

Junk funds proliferate



source: Lipper Analytical Services, Inc.

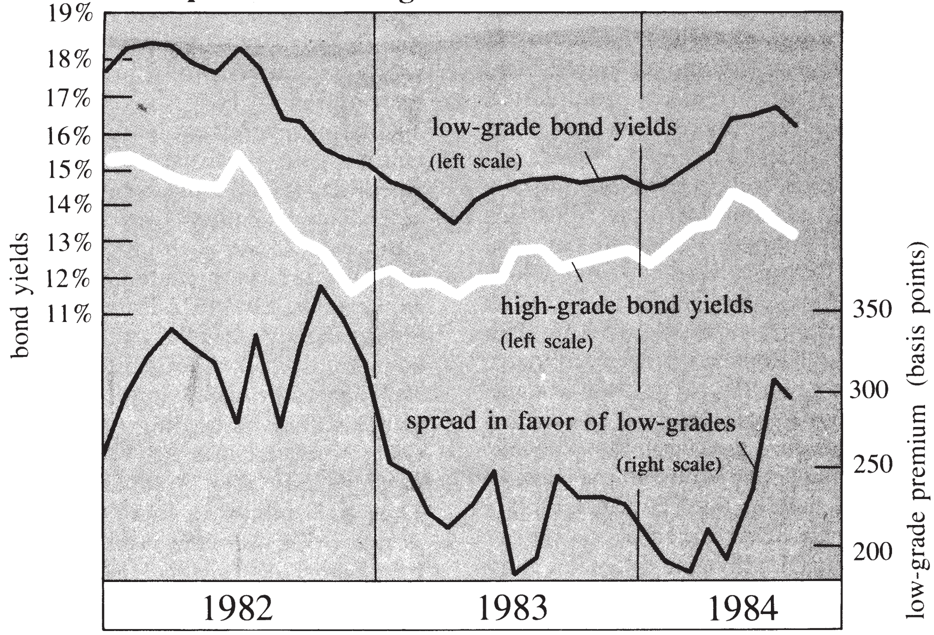
ment of $100 in high yield securities made in 1935 would have grown to $4,056 at the end of 1983, while a $100 investment in high grade securities would have grown to $713 in the same time period. Using more recent data, a $100 investment in high yield securities in 1965 would have grown to $446.73 by the end of 1983, while a $100 investment in high grade securities would have grown to $271.25."

So apparently airtight is the case for junk, so much of it has been sold and so great is the institutional appetite for it that one is obliged to doff one's hat to the junk pioneers. Standing there hatless, however, one also must scratch one's head and ask if this Wall Street concept will go the way of all fads. The question must concern everyone, in and out of the bond market. For one thing, the junk phenomenon reflects the chronic weakness in insurance-company operating results; as underwriters lose money in price wars, or through wind-damage and asbestos settlements, they are increasingly obliged to reach for yield in their investment portfolios. More basically, the rise of speculative bonds is a symptom of the piling up of debt and of the long-running deterioration of corporate finances. In that sense, the gentrification of junk amounts to the making of virtue out of unpleasant necessity.

. . .

Grant's is anti-junk. While conceding the extraordinary record of high-yield bonds, we would observe, to start with, that the present-day world is very long on debt and very short on equity. It is

Junk performance lags



source: Merrill Lynch

long on debt that may well be repudiated. According to an old investment adage, one should own the thing in short supply and shun the thing in surplus. What an illiquid world needs is cash; what it owns (or owes) in superabundance is debt. In the circumstances, the type of income-producing security to own is probably the one that affords the greatest margin of safety—that is, the one that offers the highest ratio of cash flow to interest expense. By definition, and as the accompanying table illustrates, junk bonds of any description are claims on companies without much financial leeway. (Moody's defines Ba, the highest junk grade, this way: "Bonds which are rated Ba are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds of this class.") Needless to say, the averages conceal both good and bad, and as far as the BB and B rating categories are concerned, the numbers vary enormously within each class. For instance, in 1982, while the bottom of the pile of the BB sample reported a ratio of cash flow to long-term debt of 15%, the best of the class reported a ratio of 36%. However, as a general rule, the headroom in speculative issues is short.

The rise of junk—and the fall of quality

average monthly issuance of new corporate debt ($ millions)

	Aaa/AAA	Ba/BB (and lower)
1984*	–0–	$740
1983	$102	804
1982	148	371
1981	271	593
1980	682	357
1979	730	152
1978	415	144
1977	730	86
1976	486	62
1975	714	14

*through July
source: Salomon Brothers

We have two more anti-junk declarations. The first (of which more in a moment) is that the holdings of certain speculative bonds are concentrated in a handful of financial institutions, and that that fact tends to rob the safety-through-diversification argument of some of its force. The second is that the junk idea has been carried too far. The signs (to us) are clear that a faddish consensus has formed around the person of Mike Milken and around the firm of Drexel Burnham. There is, we think, an unspoken faith that Drexel is the market and that it won't let anything happen to it. ("We get up at 4 a.m.," a Drexel bond salesman told the *Los Angeles Times* earlier this year, "and we don't go out to lunch, we don't take personal phone calls, we don't tell jokes, don't talk about the ballgame. No one in America works as hard as we do.") The truth is that markets are bigger than market makers, and that nearly every investment enthusiasm has an unhappy ending.

As can be seen from the nearby graph, junk bonds have recently underperformed. Since the rally began in June, low-rated debt has trailed not only the Treasury market but even an average of nuclear-fired electric utility bonds. (The numbers are striking. On May 31, the Merrill Lynch low-grade index yielded 194 basis points more than the Merrill high-grade index did; on August 31, the difference was 298 basis points.) Paul

H. Ross, director of corporate-bond research at Salomon Brothers, puts down the laggardliness to the specific woes of airline and oil-drilling issuers. He says that, as a matter of trading history, junk has tended to bring up the rear of bond-market rallies—it lagged governments by five months in 1982. Barring a recession, he adds, spreads between junk and Treasuries should close; however, if there is a slump in the offing, credit-quality concerns will heighten, and junk will suffer.

For ourselves, our hunch is that this time things will be different, that, in some basic way, junk has had its day.

•

Corporate leverage—an odyssey

Cash flow as a % of long-term debt for a sample of U.S. industrial companies

Investment-grade rating category	**1983**	**1982**	**1981**	**1980**	**1979**	**1978**	**1977**	**1976**	**1975**
Aaa/AAA	207%	185%	189%	199%	163%	146%	132%	122%	96%
Baa/BBB	21	29	50	34	45	38	34	43	26
Sub-investment-grade category									
BB	NA	21%	29%	33%	31%	30%	28%	27%	24%
B	NA	9	15	17	19	21	16	16	15

sources: Richard S. Wilson and Merrill Lynch & Co., *U.S. Industrial Corporations: Financial Ratios, 1973-83*, (investment-grade data); Standard & Poor's Corp., (sub-investment-grade data)