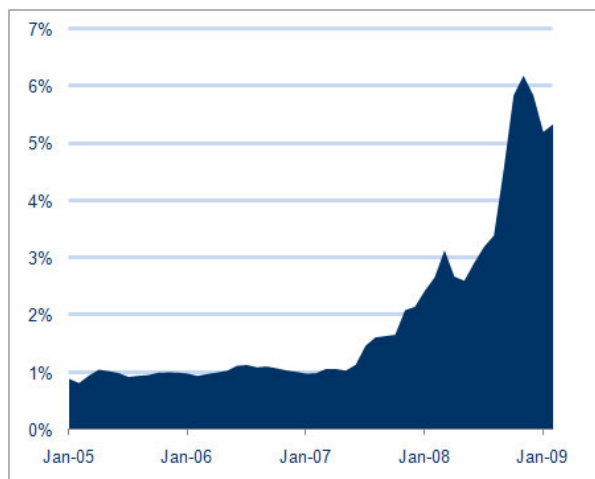


For Corporate Bond Investors, Cash Flow is King

One glance at the chart below makes clear that the term “credit crunch” is not just another example of hyperbole by the financial press. In October 2008 alone, the corporate segment of Merrill Lynch & Co.’s bond index fell 7.4% -- the largest single monthly drop since the index was developed in 1976. While spreads on corporate bonds over U.S. Treasuries have narrowed somewhat since then, they remain near historically wide levels. Given the risk that U.S. Treasuries are the next “bubble” (see our *FIXED INCOME REPORT* from March 9, 2009), and that money market rates differ from zero only by an amount that would usually be thought of as mere rounding error, one cannot help but ask whether this dramatic widening in credit spreads is an historical buying opportunity, or merely a reflection of an historic level of risk.

This chart illustrates the difference in yield between the Merrill Lynch U.S. Corporate Index and the Merrill Lynch U.S. Treasury Index.



Source: Merrill Lynch

We believe that the current environment presents an opportunity, but more importantly, we further believe that a beta-oriented, or “buy the market”, approach to

profiting from this crisis will likely end badly. Instead, we would argue that the best approach for evaluating the risk/return proposition lies in an investment process stressing issuer selectivity, and that focuses on analysis of issuer cash flow in order to properly gauge the risk of default.

In this update, we briefly review a few bond basics, and then describe our cash flow based approach. In a future update, we will conclude our corporate bond investment process overview with a discussion of several additional risk factors to consider which can significantly impact an issuer’s cash flow profile over time.

Corporate Bond Basics

Corporate bonds, unlike equities, do not represent an ownership claim in the issuer. Instead, they are I.O.U.’s – promises by companies to pay periodic interest at the coupon rate, and to then repay the principal at maturity. When valuing equities, one approach is to estimate a company’s future stream of earnings and then discount those future earnings by an appropriate discount rate. Alternatively, one can assign a certain multiple to earnings over a particular time period in order to arrive at a valuation. More mature companies, such as those which typically issue investment grade debt, tend to pay out a portion of earnings as dividends. Dividends can change over time – hopefully growing, but in lean times a company has the option to reduce, or even suspend, such payments. With a bond, on the other hand, the coupon rate is fixed, and failure to pay coupons and/or principal on time results in an event of default. In the event that such a situation is not quickly remedied, or “cured”, bondholders (along with other

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creditors) have the right to force a liquidation of a firm's assets so that they each receive their share of the proceeds. Only after creditors have been paid in full will anything left over be paid out -- first to preferred, and then to common shareholders.

Count the Cash

If someone asked an equity analyst: "What is the first thing you look at when analyzing a stock?" - he or she might be torn between answering "price" or "earnings". For a bond analyst there's no hesitation. The answer is "cash". A bond isn't going to repay any more than par, so for all but a short-term holding period, the "price" question has already been determined. If you guessed "earnings", you would be closer, but still not correct. There are a MULTITUDE of accounting rules as to when revenues can be recognized, and even more "adjustments" by management and expenses that can change what ultimately gets reported as "earnings". Cash, on the other hand, is straight forward. A company either has it, or it doesn't. And each and every day a company is either increasing its cash or spending it. A bond analyst believes as an article of faith that a credit worthy company should generate more cash by the end of a period than it started with at the beginning. And if that isn't the case -- a bond analyst starts to worry. So the first step in our selective approach to corporate bond investing is to count the cash.

Compare Free Cash Flow vs Debt

The fact is, however, that not all cash is created equally. Bond analysts want to see "free cash flow". This means cash that isn't already scheduled for such things as capital expenditures, or needed for increases in working capital. This is because a company must "cover" the amount of interest expense it has promised to pay (the total amount of the debt it has issued times the average coupon

rate -- or "debt service") without having to divert cash from other activities that grow its business. Thus, it logically follows that having first looked for positive free cash flow, the next thing to consider in analyzing a corporate bond is the total amount of debt outstanding for that issuer (and the interest rate on that debt). In some cases, a bond analyst will give the company some benefit of the doubt if the "net debt" is significantly lower than "gross debt" (if, for example, the company has a large amount of cash or cash-like instruments on hand). This is because an issuer could in theory use such cash to pay interest in a pinch. (On the other hand, a large amount of cash on a balance sheet can also result in the announcement of a large share buyback or special dividend -- occurrences which generate much howling and gnashing of teeth in bond analyst circles.)

Measure Risk - with Cash

Hence, the risk in a corporate bond really comes down to the risk that the issuer will fail to generate sufficient cash flow to meet its interest obligations and to repay the principal. So how do you measure this risk? You guessed it: cash. More specifically, you examine the variability of cash flows. Bond analysts are boring in this regard-- hating volatility, because the more variable cash flow is from quarter to quarter, or year to year, the more risk there is that a company won't have enough cash to pay interest and repay principal. When this happens, the company will have to borrow to service debt, issue shares to service debt, or sell assets to service debt. None of these are actions you want to see from an issuer of corporate bonds you own.

A corollary to this is that bond analysts are boring in that they don't like lumpiness. Lumpiness can lead to liquidity problems-- if, for example, an overly large chunk of an issuer's debt is short-term. This

For Corporate Bond Investors, Cash Flow is King *(continued)*

subjects the issuer to rollover risk. Likewise, if too large a chunk of long-term debt is maturing during too short a time period, then the issuer runs the risk that it will find it difficult to issue a sufficient amount of new bonds during that period. At the end of the day, bond analysts like to see a smooth maturity schedule dovetailed into a smooth cash flow profile. Why? Because this is the best way to ensure that, even during periods of stress such as we are experiencing currently, refunding activities go SMOOTHLY.

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Successful Investment Requires Selectivity

In sum, although the current level of corporate bond spreads appears attractive, we believe a successful investment outcome will require selectivity. Focus should be on avoiding the “losers”, and in our view such an analysis starts with looking at an issuer’s past and current cash flow. From there, however, it is crucial to consider the risks to an issuer’s cash flow profile going forward – which is where we will pick up the discussion next time.

-Eric Maisel, CFA

The FIXED INCOME REPORT is produced as a cooperative effort between fixed income analysts from **First Trust** and **BondWave**.

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