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# U.S. economic recovery in jeopardy



## Toward a double-dip recession?

Although the economic recovery in the U.S. seemed to be following its course and talks of a double-dip recession were quieting down at the beginning of the year, a slew of disappointing economic news reports prompted a sell-off that rattled financial markets this summer as uncertainty returned.

“Times have been very tumultuous,” said Colleen Denzler, Senior Vice President and Head of Fixed Income Strategy at Janus Capital Group. “The economy was growing and then we hit a lull. In addition, recent events and rhetoric in Washington added to investor unease, leading the markets to a crisis of confidence.” The sell-off was driven by three main factors:

- Sovereign debt problems in the European Union intensified and began to spread from countries including Greece, Portugal and Ireland to the core of the Euro-zone, particularly Italy and Spain. The European Central Bank intervened in the markets and purchased Spanish and Italian sovereign debt stemming the rise in yields, which were pressuring the region. But policy responses thus far have been insufficient to provide a long-term solution.
- U.S. economic data began to weaken in the spring when second-quarter gross domestic product came in lower than expected at 1.3%, which was later revised to 1.0%. Even more surprising was the revision to first-quarter GDP from 1.9% to 0.4%, proof that the economic recovery wasn't as strong as originally thought.
- Congress' inability to come to a decisive agreement on the debt ceiling, instead using it as a tool to advance each party's respective fiscal policy, accelerated uncertainty in the government and in markets. Standard & Poor's downgrade of the U.S. debt to AA+ on Aug. 5 further damaged consumer and business confidence.

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### Crisis of confidence

"In the U.S., it's a crisis of confidence with politicians who need to show the world they can get their house in order," said Daniel Janis, Senior Portfolio Manager at Manulife Asset Management. "In Europe, it's more a structural issue of fixing problems with banks if there are write-downs with sovereigns."

This crisis of confidence is especially obvious in unemployment numbers. Businesses, which have been raising cash and paying down debt, are shunning new hires, contributing to an unemployment rate hovering around 9%. The advance figure for seasonally adjusted initial unemployment was 414,000 for the week ended Sept. 3, up 2,000 from the previous week's revised figure, according to the U.S. Department of Labor.

"On the employment side, we would like to see a trend of stabilization," said Janis. "People want to have some semblance of a policy that creates jobs." President Barack Obama's \$447-billion American Jobs Act to create jobs through new spending and tax cuts was presented at the beginning of September but lawmakers and corporations didn't see it as a promising tool.

"Businesses aren't confident in their ability to plan because of the potential for higher taxes and a reduction in government spending," said Denzler. "It's not that businesses don't need to hire. Most of them are saying that they have the money to hire right now but they just don't have the confidence, so they want to wait another six months. They just don't have confidence in the road ahead."

As a result of continued high unemployment and these recent events, experts have lowered their expectations for growth although few believe in a double-dip recession.

"The key question is 'are we going into a double-dip recession,' which wasn't a question in the spring," said

Steven Huber, Portfolio Manager in the Fixed Income Division at T. Rowe Price. "We don't think we're going into a double-dip recession but we think the downside risk has increased," he said. Manulife expects growth between 1% and 2%, while its previous forecast was for growth of 1% to 3%. But the firm still believes it will be a good environment for credit products. Denzler at Janus also anticipates a positive growth under 2%. Cutwater Asset Management, a fixed income asset management firm with \$39 billion under management, views GDP registering below trend growth of roughly 1.5% for 2011 and 2.0% for 2012.

"We have been calling for a sub-par, or 'check mark' shaped recovery since the start of the rebound two years ago," said Cliff Corso, Chief Executive and Chief Investment Officer at Cutwater.

One of the reasons that the economy may avoid a double-dip recession is that the health of corporations isn't as bad as prior to the 2008 crisis, which bodes well for fixed income products, especially corporate bonds. Companies have taken advantage of low yields to reduce leverage and extend maturities. In addition, despite some spread widening in most credit markets over the summer, these markets have remained open unlike in 2008.

"In 2008, there was a major liquidity crisis around a product, subprime," explained Janis. "We don't have that degree of funding crisis currently."

Denzler said her firm continues to see "positive fundamental indicators at the individual company level as conservatism and capital structure prudence remain core tenets within corporate America."

### Toward shorter economic cycles

Although most experts agree that the situation isn't as bad as prior to the 2008 recession, many of them be-

lieve the current economic cycle is unlike any others.

“Typically, coming out of a recession, growth is much stronger,” said T. Rowe’s Huber. For Cutwater, the economy has entered a new environment it calls the “Abnormal Normal,” which produces slower economic growth, increased volatility and shorter economic cycles. It differs greatly from the previous period often referred to as the “Great Moderation,” which was characterized by longer economic cycles, lower interest rates and tighter credit spreads.

“One of the many reasons for this is that the Great Recession was not caused by a classic inventory shock but rather a debt shock,” said Corso. For instance, the ratio of total debt-to-GDP in the U.S. skyrocketed to about 350% just prior to the crisis. To put this number in perspective, this ratio was approximately 250% during the Great Depression. “It will take a lot of time and sacrifice to bring this ratio down to a sustainable level, and if the recent debt debate in Washington is any indicator of how we will tackle this problem over the long term, we’re in for a lot of pain,” he said.

“Another reason we think the Abnormal Normal will persist for some time is that lack of monetary policy power in the system. We equate monetary policy to penicillin shots, and the more shots you receive, the less effective they become. With short-term rates effectively at zero and the first and second waves of quantitative easing well baked in, how effective would a third quantitative easing be?”

Corso believes volatility will continue for the next 12 months due to Europe bubbling, a fiscal issue and election in the U.S. and many emerging market central banks on a tightening campaign, a classic highly correlative recession driver.

### Emerging markets: Cause for concern or growth driver?

Fixed income experts are also paying close attention to the health of emerging markets and whether they could join a potential global recession or whether they will continue to pull the rest of the world. This is an important discussion because many managers see emerging markets as offering new opportunities in the fixed income world but these opportunities will highly depend on where emerging markets are heading. The typical view is that there will be a continued growth from emerging markets, albeit lower than in previous years. This thought, which has almost become a universal truth, has many money managers nervous. “We continue to see global growth being driven by the emerging market countries with U.S. growth carried by business investment and global sales, helped along by a weaker dollar, a relative value proxy, and higher exports,” said Corso. “But we are naturally becoming more concerned that the world is unprepared for slower growth out of the emerging regions if that were to occur. This could be caused by many things, for example, the vigilant Brazilian Central bank,

As the U.S. economy shifts and struggles to recover from one of the most painful crises in its history, macroeconomic events are becoming increasingly important to understand how to invest in fixed income and what the main risks are in the asset class.

might keep short rates too high for too long.”

Denzler of Janus is concerned about slower growth in China as much of the Chinese economy is driven by consumers in the Western world, who are still trying to reduce debt and moderate their spending.

Janis of Manulife is more positive on China. “China is on a high single-digit growth path,” he said. “It could slow down because of interest rate measures, but there’s no recession on the horizon.”

“Chinese growth is slowing,” echoed Huber. “But we don’t expect a hard landing. They have been taking additional steps to rein in credit.” He added that across emerging markets, inflation has been a concern for much of the year, for example in Brazil. “But currently, with global growth concerns, we’ve seen Brazil cut rates.”

As the U.S. economy shifts and struggles to recover from one of the most painful crises in its history, macroeconomic events are becoming increasingly important to understand how to invest in fixed income and what the main risks are in the asset class. “I really do believe that the risk in fixed income markets has changed, now coming more from interest rates, sovereigns and from the fiscal side,” concluded Denzler. ●

# Close-up on corporate credit



After a volatile summer, opportunities abound at home and abroad

**R**isk increased over the summer in corporate credit as a market correction rattled spreads and brought issuance to a standstill. But with lower valuations and an increasingly global fixed income world, investors are finding new opportunities, making the corporate bond market a compelling, ever more diversified investment arena.

The investment-grade corporate bond market went through a significant repricing starting at the end of July, with spreads widening to roughly 200 basis points as of the end of August from 140 basis points at the beginning of summer. "The widening has been significant," said Colleen Denzler, Senior Vice President and Head of Fixed Income Strategy at Janus Capital Group. "Corporate credit has really underperformed in August and early September, but as a result, many investors now view this sector as being more attractive. Companies with strong balance sheets and flexibility will do well. They don't need 2.5% growth to excel. Companies that

aren't as financially stable will suffer."

August 2011 will likely be one of the worst months of negative excess return for credit, rivaling with the financial crisis of 2007 and 2008, say experts. But for investment-grade credits, although spreads have widened, yields have remained low and will likely stay low, benefiting from low Treasury rates, which makes the asset class attractive for both issuers and bondholders. According to Moody's Investors Service, the 2.79% average yield of single-A corporate debt as of the end of August falls far short of the historical median of 5.36%.

"All-in, yields remain very low, under 4% for the investment grade corporate market," said Steven Huber, Portfolio Manager in the Fixed Income Division at T. Rowe Price. "When Treasuries rallied, yields went below 3.5%."

During the market sell-off, financial services firms and cyclical corporations took the brunt of the pain with the basis between the credit index and the bank sector

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## Janus Core Plus Bond Composite has far outpaced its peers in delivering risk-adjusted returns.

Period ended 6/30/11



Source: eVestment Alliance

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### Past performance cannot guarantee future results. Investing involves risk including risk of loss of principal.

eVestment Alliance's (eA) software has been used by Janus Capital Group Institutional to create the performance, rankings and risk related exhibits. A fee was paid to the firm for the use of the software. The results are presented gross of fees and are annualized for periods of one year or longer.

Favorable Information Ratio Rankings are not indicative of positive absolute performance.

Janus Core Plus Bond Composite benchmark is Barclays Capital U.S. Aggregate Bond Index.

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doubling to more than 100 basis points, according to Jesse Fogarty, Senior Portfolio Manager of Corporates at Cutwater Asset Management.

“There seems to be two different markets in investment-grade credit,” added Huber. “Industrial non-cyclical companies have prompted a huge demand for new issues and so spreads are tighter. Financials have wider spreads because there are concerns with the economic recovery and the turmoil in Europe.” But views differ as to whether bonds of financial services companies present attractive opportunities.

Huber thinks it is too early to invest in bonds of financial services companies. “In terms of value, we favor industrials over financials, but with the yield difference, at some point financials will be more attractive as the recovery progresses and their mortgage and legal issues are resolved,” he said. Cutwater is more bullish and has selectively added to senior bank debt positions, in particular in the front of the curve where the firm believes the bonds offer good value, driven by strong fundamentals and a robust technical picture. “In the continual search for yield, investors can triple their yield relative to Treasuries by buying high-quality senior banks in the five-year part of the curve,” said Fogarty. “From a fundamental perspective, banks are in a much different situation than the 2007/2008 financial crisis, with capital ratios at highs, leverage vastly improved, and much better asset books. Finally, increased financial regulation bodes well for senior bonds as banking entities become more utility-like from a risk/return perspective.”

Janus has made the case for months that corporations are in very strong financial shape and would be able to withstand a slowing in the growth of the economy. “We still believe that to be true based on our research. Given the relative attractiveness of the asset class in a low-yield environment, we believe corporate credit is still in a position to do well and offers the best relative yield and risk/reward versus other fixed income sectors, despite tighter spreads. We have been recommending our clients

have more flexibility to allocate to spread products such as corporate credit to shorten the duration of a portfolio so it is less sensitive to interest rates, and afford more yield to protect capital in a rising rate environment,” Denzler said. “In addition, the ability to move a significant allocation to cash and cash equivalents can be used as a hedge in volatile and uncertain markets.”

### Issuance slows in August, still strong for the year

The low level of yields has caused a lot of new issuance and has allowed companies to build cash, while the spread premium for investors has remained advantageous. “New issuance is strong this year because companies have taken advantage of lower rates and there’s also very strong investor demand to gain additional yield over Treasuries without going too far down in credit quality,” said Huber.

Broadly speaking, global corporate issuance, which came in at \$126 billion in August, fell by 30% from July as a result of spread widening. The high-yield new issue market effectively shut down as investor risk aversion spiked and there was also a sharp contraction in financial institutions issuance, as noted by Moody’s. The high-yield primary market only returned in the first week of September with the announcement of two deals, both of which remained subdued: These were a \$200 million bond by refiner Calumet Specialty Products Partners and German healthcare group, Fresenius Medical Care AG, priced at \$400 million, and a EUR400 million bond deal.

But despite August’s weak issuance numbers, year-to-date issuance in 2011 is still slightly higher than last year. “Issuance has gone up in investment grade and in high yield,” said Denzler. “With yields as low as they are, it’s a great time to refinance. For the most part, there’s been access to liquidity.” For most of the year, corporations have used debt issuance in a conservative manner, mostly for refinancing purposes and to extend maturities. “But companies were also starting to raise debt for shareholder-friendly actions again before summer because they

As investors learn from the mistakes of the 2008 financial crisis, they are increasingly seeking investment opportunities outside of the U.S. in addition to domestic investment-grade and high-yield corporate bonds.

had already paid down so much debt," said Denzler.

In an Aug. 29 report, Fitch Ratings wrote that from a bondholder perspective, funds borrowed for purposes other than refinancing constitute a modest credit negative because managements are likely to feel pressure to eventually put borrowings to work to boost shareholder value through increased capital expenditures, share repurchases, dividend hikes or merger and acquisition activity.

Investment-grade companies that took advantage of low yields so far this year include Walt Disney Co., Coca-Cola Co., AT&T Inc. and Procter & Gamble Co. "Few of the entities that have issued debt at recent levels have earmarked borrowings for shareholder-friendly actions," the ratings agency wrote. However, Fitch notes that in many instances, issuer liquidity was robust prior to issuance and incentives to keep excess liquidity warehoused on the balance sheet may erode, as management eventually comes under pressure to earn their cost of capital. So far this year, mergers and acquisitions have represented roughly 20% of all high-yield issuance, still a modest level, according to Huber. He noted that it was around 50% in the 2006 and 2007 timeframe. "On the high-yield side, a lot of new issue activity has been for refinancing purposes," he said. "So far this year, roughly 50% or more of issuance is used for refinancing."

### High yield credits hit harder

Companies aren't out of the woods yet. If spreads continue to widen, it could crimp earnings and limit access to needed capital, especially for high-yield companies, which haven't benefited from lower yields like their higher-rated counterparts. Earlier this year, strong mutual fund inflows into high-yield bonds and leveraged loans drew spreads in to the mid 500 basis points. But starting at the end of July, that trend began reversing, which drove spreads to the mid 700 basis points.

The yield on U.S. high yield bonds reached 8.45% as of the end of August, up 0.19% from its year ago level and

1.83% higher than this year's bottom. But thanks to the heavy refinancing activity in the past couple of years, corporations have the ability to wait out the current drop in liquidity, according to Moody's.

Additionally, in the first week of September, high-yield mutual funds saw an inflow of \$577 million, the first positive inflow since the end of July. Despite this reversal, bank loan retail mutual funds continued to see funds withdrawn.

The summer spike in high-yield spreads also lifted the number of issuers classified as distressed, which are defined as those with bonds having spreads in excess of 1,000 basis points. Such distressed issuers made up 8.9% of all issuers at the end of July, according to Moody's. The risk with having a greater number of distressed issuers is that the speculative default rate spikes.

"The five-year cumulative default rate implied by recent high-yield spreads is well north of the Great Depression peak default rate," said Gautam Khanna, Senior Portfolio Manager of High Yield and Global Strategies at Cutwater Asset Management. "Spreads are particularly attractive in the double-B segment with current spreads at 554 basis points and wider that are compensating investors for a 42% level of default that will far exceed the default rate within that credit quality," he added.

"During this spread sell-off, while higher quality has held in better in absolute terms, it has underperformed historical relationship-driven expectations. We believe the relative underperformance of higher-quality high yield is due to liquidity-driven technicals and presents us an opportunity to add to our high yield allocation in high quality credits at very attractive spreads."

The default rate also ticked lower in August. Moody's global default rate came in at 1.8% in August, down from 5.1% a year earlier. In the U.S., the default rate was 2.1% in August, down from 5.1% a year earlier. Moody's expects the rate to end the year at 1.5% before rising again up to 1.9% by August next year. Again, this low rate was made possible by easy credit, which has allowed companies

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to refinance and renegotiate their credit facilities and to avoid missing payments.

"Defaults are low, as companies have improved balance sheets," said Huber. "For a couple of years, a robust new issue market has allowed companies to refinance debt, extend maturities, raise cash on the balance sheets. This doesn't eliminate the risk, but puts them in much better shape to weather a slow growth environment."

### Fixed income goes global

As investors learn from the mistakes of the 2008 financial crisis, they are increasingly seeking investment opportunities outside of the U.S. in addition to domestic investment-grade and high-yield corporate bonds. With the global economy stronger than in the U.S. in many ways, they are seeking to find investments all over the globe and in particular in emerging countries. While U.S. gross domestic product was \$14.5 trillion for 2010, the same as Brazil, Russia, India and China, or BRICs, plus Asia combined, the bond market in the U.S. is \$32.5 trillion, dwarfing that of the BRICs and Asia, which stands at \$1.8 trillion, according to Dan Janis, Portfolio Manager at Manulife Asset Management.

"As Asia excluding Japan transitions from an export-driven economy to a consumer-driven economy, the local bond markets will further develop to support the growth of the middle class in this region," he said. "That will present a massive opportunity in the next 10 years."

His firm decided to get exposure to bonds from outside the U.S. with its global multi-sector fixed income strategy, which holds \$10 billion in assets under management. Although the strategy isn't new, it has gained traction in the last two years with institutional investors particularly focusing on it in the past nine to 12 months. "A lot of consultants want their portfolios to be dynamic," Janis said. "That's a different theme from five years ago when they wanted to be benchmark centric and put you in a box. Investors are looking for ways to diversify and take on more yield and managed risk."

Most demand has come from defined benefit plans, while there has been less demand from endowments and foundations, although it fits their risk/return profile. "I expect them to express an interest," said David Zielinski, Fixed Income Product Manager at Manulife.

Investing on a global basis offers not only currency diversification and protection against rising interest rates, but also the potential for equity-like returns with fixed income volatility.

As of July 31, 46% of the Manulife portfolio was in foreign bonds, including some bonds from developed countries like Canada, Norway, Australia, New Zealand and Sweden, and some from emerging markets including Singapore, Korea, Malaysia, Indonesia and the Philippines. In these emerging markets, Manulife focuses mostly on corporate bonds or supranationals, mostly dollar-denominated because local currency bonds lack sufficient liquidity. "As local markets develop and liquidity improves, we expect to embrace more local currency bonds," said Janis.

Global investing has become an essential part of a well-diversified portfolio. "Going global offers investors a chance to generate income from a much broader opportunity set, in some cases with greater potential yield," said Denzler. "Just as more U.S. companies are tapping into markets abroad for greater opportunity and potential stability, bond investors can benefit from sources of cash flow that are less correlated to their domestic market."

The Barclays Global Aggregate Bond index is comprised of roughly 61% of non-U.S. bonds, compared with 34% in 1991. "The G7 economies are expected to lose approximately 10% market share of world GDP, on a purchasing power parity basis, over the next few years. A forecast of approximately 35% market share, down from 50+% in the early 1990's. This market share is being picked up by Emerging Asia, and the story there, not surprisingly is the growth of China and India. This is a structural change in the fortunes of the globe and not simply a cyclical phenomenon which we believe fixed income investors in a Global Portfolio should exploit," said Khanna of Cutwater. "The fundamentals of many of the well-established emerging economies have improved and continue to improve." He added that 70% of emerging markets tradable bonds are currently investment grade.

Some of the criteria Cutwater looks for when identifying emerging economies for fixed income investments include vibrant economies that are exhibiting sustained, above trend, GDP growth; countries with responsible central banks that are disciplined in fighting inflation; countries with stable to appreciating currencies; and countries with deep capital markets. According to Cutwater, Brazil fits most of these criteria, despite its high inflation, and so does Mexico, although Khanna thinks the trade has been mostly played out there, as well as in Chile, India and Malaysia.

"The diversity of circumstances within emerging economies argues for important country-specific differences within the broader cycle," said Khanna. "This is where systematic research and detailed monitoring of country-specific macroeconomic conditions pays off. Only exceptionally emerging market trades are good trades."

Huber at T. Rowe Price also likes Brazil and Mexico, where his firm invests in non-dollar sovereign bonds as well as corporate bonds. In China, it invests in currency forwards rather than bonds, since the bond market is less developed. "In countries where we want the currency risk but not the credit risk, we buy currency forwards," said Huber. But experts note that investors should be careful in seeking managers and should focus on those with long-term track records and with a global network of resources and infrastructure. Only once investors have found such skilled managers, will they be able to achieve enhanced returns and diversification, which has become increasingly important in the past several years.

"Diversification makes the most sense in a portfolio given the heightened uncertainty and higher volatility, and should ideally be global to take advantage of a more diversified universe," said Huber. ●



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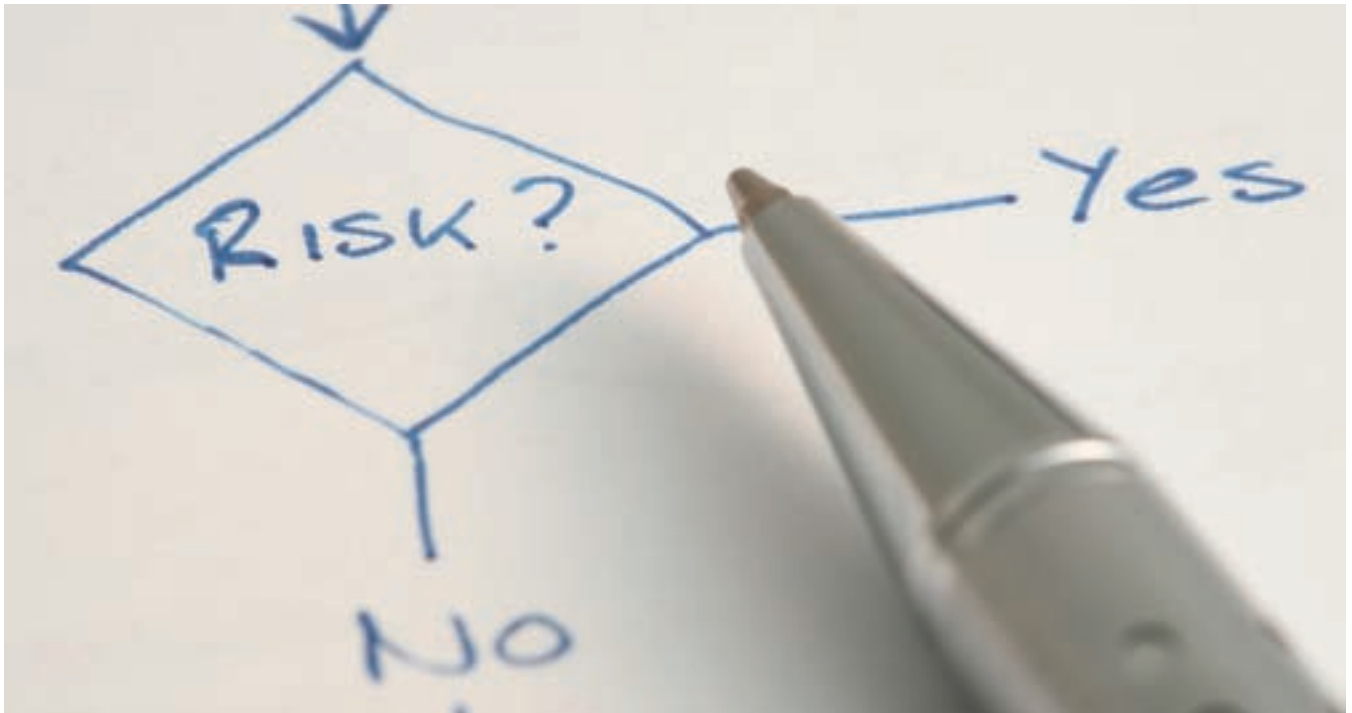


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\* As of July 31, 2011, \*\* As of June 30, 2011

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# Securitization is back



But risk-taking remains subdued

Structured credit products suffered greatly during the recession of 2008 as problems with subprime real estate first spread to various types of mortgage-backed securities. This was followed by other investment vehicles in the securitization world, including collateralized loan obligations.

Although many facets of the real estate market in the U.S. continue to deteriorate, structured products have come back to life.

## CMBS 2.0: Revival of a market

As the CMBS market made its comeback in the past 12 months, issuers and underwriters have made sure that the structures of transactions are more conservative than at the top of the market in 2006 and 2007, for example, drastically reducing the leverage of deals as well as the power of special servicers in restructuring. As a result, issuance soared. From virtually no issuance in 2009, roughly \$10 billion worth of new CMBS were issued in 2010 and predictions for 2011 called for \$25 billion to \$40 billion in new CMBS.

The CMBS market certainly looked promising at the beginning of the year but issuance slowed down mid-year and stood at roughly \$22 billion as of July.

The slowdown in issuance was due to several factors:

In July, Standard & Poor's withdrew its rating on a CMBS issue after it identified an error in its methodology, causing the issue to be pulled out of the market and issuance to come to a halt. To make matters worse, concurrent with the S&P announcement, worries about the U.S. economic growth and the possibility of a double-dip recession intensified and spreads started to widen. Issuance of CMBS has since resumed but remains subdued and most importantly has transitioned to the public market, where investors require more collateral - 30% as opposed to 20% with private placement deals -- to make up for the added risk, explains Colleen Denzler, Senior Vice President and Head of Fixed Income Strategy at Janus Capital Group.

"Since the 2008 crisis, most CMBS issues were in the 144A private placement market where issuers can disclose a greater level of information relative to public markets. With issuance shifting from private to public placements, recent deals have less information and thus are less valued," said Denzler. "In an uncertain environment, investors want even more to be able to analyze the risk they're taking."

As a result, investors should focus on the highest tranches of CMBS deals.

"CMBS really have exhibited extreme volatility," said Steven Huber, Portfolio Manager in the Fixed Income Group at T. Rowe Price. "You're currently getting decent value in the higher-quality tranches at the very top of the capital structure. But even there, you still can have significant spread volatility."

"Our preference is for up-in-capital-structure CMBS exposures," which provides a necessary margin of safety, concurred Rich Talmadge, Head of Structured Credit at Cutwater Asset Management. He noted that new issue AAA classes are demonstrating good relative value since they have sold off from their highs back in early May. Further, Cutwater favors super-senior CMBS over real estate investment trusts. "Quite simply, CMBS spreads, even at the 30% credit enhanced super-senior level, have been oversold in reaction to macro market technicals whereas REIT spreads have remained tight to corporate spreads, even beyond what the stronger property and sponsor quality in REITs might warrant," Talmadge added.

### Agencies MBS and policy risk

Still in the real estate world, agencies MBS have been attractive but not risk-free. Huber reckons the sector presents opportunities for defensive purposes. "Valuations are attractive at wide spreads," he said, adding that "the risk currently is more on the policy side."

Denzler explains that the Federal Reserve currently owns a big chunk of agencies mortgages with very low

rates. As a huge refinancing wave approaches, a lot of MBS will get called, providing cash to investors. "They can buy new mortgages but the new issues are 30 years with higher durations," she said. "You're getting short bonds called away from you and being replaced by longer-duration bonds. We are so close to zero that even if they rally, it's not a very good trade off."

### Safety in ABS

For its part, the asset-backed securities market remains well structured and safe, although returns are low. The safety is due to a good diversity in the underlying collateral, a strong subordination and great transparency of transactions.

"There's been low risk, low volatility in ABS," said Huber. "Spreads are much lower than other securitized sectors and there's not a lot of juice. It's a relatively safe sector, but with low return expectations."

### Stick to the top with CLOs

During the 2008 crisis, CLOs, a form of collateralized debt obligations made of high-yield leveraged loans sliced into securities, suffered from the general market sell-off and became illiquid at times. Issuance, which had reached a peak in 2007 of \$91.1 billion, froze, with only \$3.4 billion of CLOs issued in 2010, according to Bloomberg data. The CLO market has slowly returned with \$7 billion in new deals as of the end of August, and estimates by J.P. Morgan of \$10 billion to \$15 billion for the year. Still, the space is victim to periodic bouts of illiquidity and price volatility, which investors have to be willing to weather.

With that in mind, experts recommend to focus on investments at the top of the CLO capital structure as they provide access to diversified pools of senior secured leveraged loans while being well-protected against future economic downturns from the credit enhancement provided by more subordinated tranches and by other structural protections, according to Jason Cameron, Senior Portfolio Manager for CDOs and CLOs at Cutwater.

"At current valuations these tranches are providing investors with attractive risk-adjusted returns that are defensive against interest rate rises since CLO liabilities generally are issued with floating rate coupons benchmarked to London interbank offered rate," he said. "As an asset class, U.S. senior secured leveraged loans have exhibited stable fundamental values through time due to the value of their collateral and seniority versus other creditors. And CLOs have proven to be relatively stable and resilient in part due to the underlying value of the loan assets backing them."

He added that CLOs have been the only CDO sub-sector that has seen a return of a primary market post-crisis. Although risky and sometimes lacking liquidity, structured products have become a must in the portfolios of investors wanting to emphasize diversification. ●

# Opportunities In Emerging Market Corporate Bonds



**Mike Conelius**, portfolio manager of T. Rowe Price's Emerging Market (EM) Corporate Bond Strategy, has been managing dedicated EM portfolios since 1994. Below, Mike responds to questions about the EM corporate market's development, T. Rowe Price's integrated research approach, and the potential investment benefits of EM corporate bonds.

## How has the EM corporate market evolved?

There is a broader range of opportunities available within the asset class. Ten years ago, corporate issues that came to market were mainly from traditional extractive industries. Today, more companies are coming to market that reflect the rising wealth of the emerging market consumer—Brazilian pharmaceuticals, Argentine shopping malls, Chinese homebuilders, and Middle Eastern shipping companies.

We believe that corporate bonds provide one of the best fixed income opportunities to express the theme of global rebalancing, as the source of emerging market growth rotates from external to domestic demand.

## What is your investment approach?

An integrated, bottom-up research process is central to our philosophy because it allows for early identification of opportunities in EM corporate debt. T. Rowe Price's four-member dedicated EM corporate bond team, located across three regions—Asia, Europe, and North America—is supported by 17 global sector fixed income specialists.

As well as assessing traditional credit metrics (for example, company leverage, capital expenditure plans, and cash flow levels), our credit analysts look beyond the balance sheet to gain deeper insights into companies. They blend the credit perspective with both equity and sovereign analyses.

Our emerging market equity team, established in 1985 and with 25 members located around the world, helps our fixed income analysts gain access to company management where they have existing relationships. Proximity to management is crucial, particularly since corporate transparency can be more limited in some emerging markets. Price movements of bonds can be affected by rumors and other factors that may only be available to locally based analysts.

Alongside equity, the sovereign input is highly important to corporate bond analysis. Sovereign risk has been found to have a significant influence on company risk in the emerging markets.<sup>1</sup>

Many emerging market credits trade in sentiment with their related sovereign debt, particularly as they tend to benefit from direct and indirect state support.

Our credit, equity and sovereign analysts frequently travel together to meet with companies in various emerging countries, helping to generate investment ideas for our portfolios.

## What are the benefits of EM corporate debt?

EM corporate bonds can offer investors several potential benefits, including:

- an attractive yield (5.7% as of July 29, 2011);<sup>2</sup>
- a higher average credit quality rating (BBB) relative to EM sovereign and high yield debt;<sup>3</sup> and
- attractive returns. Over one- and three-year time periods ending July 29, 2011, EM corporate bonds have outperformed global investment-grade corporate bonds and U.S. investment-grade corporate bonds.<sup>4</sup>

Corporate credit fundamentals improved significantly over the last 12 months. Fundamental improvements should continue in 2011 based on evidence of declining net leverage ratios, rising cash flow levels, and increasing EBITDA levels.

Going forward, potential growth rates for emerging economies are projected to continue surpassing those of developed markets, leading to further expansion of the EM corporate bond asset class. Knowledge of the countries and companies in the emerging markets, built up over many years and synthesized through a collaborative research process, should provide our credit team with a critical information advantage as this asset class continues to evolve.

**For more information, contact Keith Lewis at [keith\\_lewis@troweprice.com](mailto:keith_lewis@troweprice.com).**

**To learn more about our current perspectives, visit us at [troweprice.com/sectorpulse](http://troweprice.com/sectorpulse).**

<sup>1</sup>Moody's found that nearly three-quarters of emerging market corporate or sub-sovereign defaults occurred during a sovereign crisis between 1995 and 2008. *Emerging Market Corporate and Sub-Sovereign Defaults and Sovereign Crises: Perspectives on Country Risk*, Moody's Investors Service, February 2009. <sup>2</sup>J.P. Morgan's Corporate Emerging Market Bond Index Broad Diversified. <sup>3</sup>As of July 29, 2011. <sup>4</sup>As of July 29, 2011. Representative indices include J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (EM Corporate Hard Currency), Barclays Global Aggregate Corporate Index – USD Hedged (Global Investment-Grade Corporate Bonds), and Barclays U.S. Investment Grade Corporate Index. Past performance cannot guarantee future results.