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The Role of High Yield Bonds

PIMCO believes that high yield bonds—those rated below ‘BBB-’ by Standard & Poor’s and below ‘Baa3’ by Moody’s—can play an important role in many portfolios.

High yield bonds typically offer higher interest rates than Treasuries or high-grade corporates and hold the potential for capital appreciation in the event of a rating upgrade, an economic upturn or improved performance at the issuing company. The high yield sector also generally has a low correlation to other sectors of the fixed income market, which can improve the diversification of a broad allocation to fixed income.

What Makes a Bond High Yield?

Rating agencies evaluate bond issuers and assign ratings based on their assessment of the issuer’s ability to pay interest and principal as scheduled. Issuers considered to have a greater risk of not paying interest or principal on a timely basis are rated below investment grade. These issuers must pay higher interest rates to attract investors to buy their bonds (see table below).

Bond Credit Quality Ratings

Credit Risk	RATING AGENCIES		
	Moody’s*	Standard & Poor’s**	Fitch IBCA**
INVESTMENT GRADE			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
NOT INVESTMENT GRADE			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

*The ratings from Aa to Ca by Moody’s may be modified by the addition of a 1, 2 or 3 to show relative standing within the category.

**The ratings from AA to CC by Standard & Poor’s and Fitch IBCA may be modified by the addition of a plus or minus sign to show relative standing within the category.

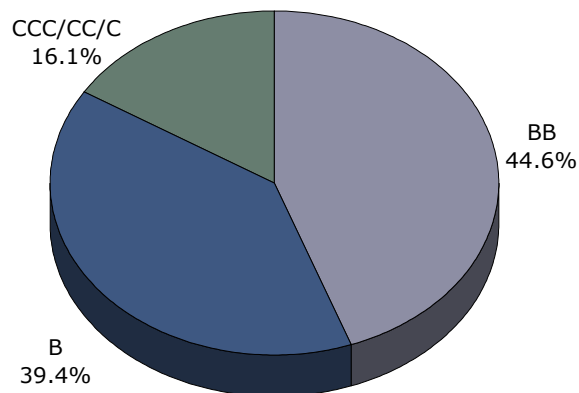
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Securities rated below investment grade are also referred to as “junk” bonds, although that term is sometimes used to refer only to the lower tiers of the non-investment-grade ratings; high yield bonds rated ‘Ba’ by Moody’s or ‘BB’ by other rating agencies are often not considered junk. Issues rated ‘B’ and ‘BB’ account for more than three-quarters of the outstanding principal of high-yield securities, with the lower-rated tiers in the minority (*see chart below*). Emerging market bonds are also below investment grade, although these bonds have their own characteristics and tend to be considered a separate asset class. When considering credit ratings in a portfolio context, it is important to note that the credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Ratings Distribution of the High Yield Market

By Outstanding Principal Amount
as of September 30, 2005*



Source: Merrill Lynch
* Excludes defaulted issues

Who Issues High Yield Bonds?

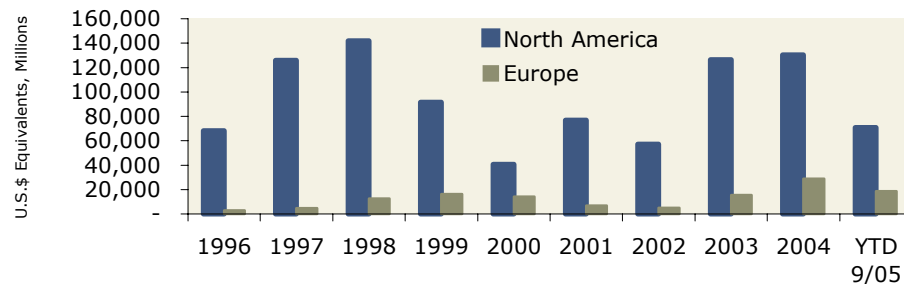
While diversity has grown in the high yield market, the major issuer remains North America with the U.S., in particular, dominating issuance. As the chart below shows, however, European high yield bonds have demonstrated an upward trend in issuance over the past few years and represent more than one-fifth of the total current year issuances for the two regions through the third quarter of 2005.

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Global High Yield New Issue Volume

Year-to-date as of 9/30



YTD Issuance as of Sept. 30, 2005

Source: Merrill Lynch

Many companies that are capital-intensive or refinancing debt turn to the high yield market to finance their capital needs or consolidate and pay down bank lines of credit. In the 1980s, many high yield bonds were used to finance speculative acquisitions, mergers or leveraged buyouts, and some are still used for this purpose.

Corporate issuers of high yield bonds also include both “fallen angels,” which are former investment-grade companies whose debt has been downgraded, and “rising stars,” which are emerging or start-up companies. Debt ratings of the fallen angels can sometimes be upgraded to investment-grade status if their prospects improve while rising stars can see their ratings upgraded once they achieve the necessary size, capital strength, or operating history.

Benefits and Economic Cycle Positioning

High yield bonds offer investors a number of potential benefits, including the following:

- Enhanced current income.** For much of the 1980s and 1990s, high yield bonds typically offered about 300 to 400 basis points of additional yield relative to Treasury securities of comparable maturity, according to The Bond Market Association. According to Merrill Lynch, high yield bonds offered about 306 basis points of additional yield relative to Treasuries as of Sept. 30, 2005.
- Capital appreciation.** An economic upturn or improved performance at the issuing company can have a significant impact on the price of a high yield bond. This capital appreciation is an important component of PIMCO’s total return approach to bond investing. Positive events that can push up the price of a bond can include ratings upgrades, improved earnings reports, mergers or acquisitions, management changes, positive product developments or market-related events. On the other hand, negative credit events or an economic

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downturn may have a negative effect on the price of high yield bonds. Like equities, high yield bond prices are much more sensitive to the economic outlook and corporate earnings than to day-to-day fluctuations in interest rates. In a rising-rate environment, as would be expected in the recovery phase of the economic cycle, high yield bonds would be expected to outperform many other fixed income classes. Although both equities and high yield bonds tend to rise in value during a recovery, returns on high yield bonds tend to be less volatile because the income component of the return is larger, providing an added measure of stability. Also, bondholders usually have priority over stockholders in a company's capital structure in the event of bankruptcy or liquidation. This means that an investor considering a company—or group of companies—that has a below-investment-grade rating will face less default risk investing in that company's bonds than purchasing the company's stock.

- **Relatively low duration.** Low duration, or sensitivity to changes in interest rates, tends to lower volatility. High yield bonds are typically issued with terms of 10 years or less and are callable after four or five years. Higher-rated borrowers such as the U.S. Treasury and investment grade corporations are able to issue securities with longer maturities (and longer durations).
- **Diversification benefits.** High yield bonds are considered a separate asset class and offer different risk and reward characteristics. High yield bonds typically have a low correlation to other fixed income sectors, which means that adding high yield securities to a broad fixed income portfolio may enhance portfolio diversification. Diversification does not ensure against loss but it can decrease risk and improve the consistency of portfolio returns.

Risks of Investing in High Yield Bonds

High yield bonds typically pay higher interest rates, or yields, than investment-grade bonds, because they carry greater risks. First, companies that issue high yield bonds have a greater chance of defaulting on their bonds, or failing to make scheduled interest and/or principal payments. Second, if an issuer's financial health deteriorates, which may be more likely if the company is below investment grade, credit rating agencies may downgrade the bonds, which can reduce their value. Also, companies rated below investment-grade may be more negatively affected by economic downturns and adverse market conditions than those with higher credit ratings.

Investors can mitigate the risks in high yield bonds by diversifying their holdings across issuers and across industries and by carefully monitoring the financial health of the companies they invest in.

Conclusion

High yield bonds can play an important role in a portfolio, enhancing return potential while improving diversification. High yield bonds are similar to equities in that they tend to be heavily influenced by developments in the corporate sector, but the income

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provided by high yield bonds tends to make these securities less risky than stocks. From a portfolio perspective, high yield fits into the space between equity and fixed income.

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Each sector of the bond market entails risk. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to such factors as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. When interest rates rise, the value of fixed income securities generally declines and there is no assurance that private guarantors or insurers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments which may be enhanced when investing in emerging markets. Equity portfolios are subject to the basic stock market risk that a particular security, or securities in general, may decrease in value

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