

## A Roller Coaster Year Ends

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### Market Performance

Down hard in September, up big in October, down hard in November, up big in December — the last few months in the high yield market have certainly been a roller coaster ride! After being down 2.21% in November, the Bank of America/Merrill Lynch U.S. High Yield Master II Constrained Index (HUC0) was up 2.48% in December as risk assets rallied on the back of better economic news out of the United States and hopes that there will soon be a more permanent resolution to the sovereign crisis in Europe. For the fourth quarter and the full year, the HUC0 was up 6.19% and 4.37%, respectively. The fourth quarter was a mirror image of the third quarter, when the HUC0 lost 6.33%.

Spreads tightened 41 basis points from 780 basis points at the end of November to 739 basis points at the end of December. The spread on the index hit its month-end peak in September, at 842 basis points, and its month-end narrow in April, at 476 basis points. For December, BB, B and CCC bonds returned 5.54%, 2.52% and 3.16%, respectively. For the year, BB, B and CCC bonds returned 6.12%, 4.65% and -1.40%, respectively. The end-of-year spreads were:

#### Option Adjusted Spreads in Basis Points (December 31, 2011)

HUC0	739
BB	545
B	749
CCC	1,348

### Review and Outlook

Our strategy outperformed the index modestly in December. The strategy underperformed modestly for the fourth quarter, and with a return of 7.14% outperformed by 277 basis points for full-year 2011. As we have noted each and every month, our performance is consistent with our strategy, as we expect to outperform when the high yield market is under pressure and underperform when the high yield market is rallying, as it did in the fourth quarter. Our lack of CCC bonds helped our full-year performance, though it hurt for the fourth quarter.

The benefit of high yield bonds is the consistency of the high coupon income. Unlike stocks, however, the upside price potential of high yield bonds is capped.

Companies never repay bondholders two or three times what they borrowed. Companies will frequently elect to redeem their bonds prior to maturity, and the bondholder will be paid a small premium to par. Most high yield bonds are issued with maturities of seven, eight or ten years; bonds generally cannot be redeemed until about halfway to their maturity. High yield bonds can and do therefore trade a premiums to par (\$100), but the index rarely trades more than 3 or 4 points above par.

Because the price upside of high yield bonds is capped, it is important to look at their price when considering their return potential. As of the end of December, the average price of high yield bonds in the HUC0 was \$97.34. The average price of BB and B bonds (the H0A4 index) was \$101.31. Is there room for further price appreciation? Yes, but given the current prices on the average high yield bond, most of the return potential comes from the current yield the bonds generate. The current yield on the HUC0 index is nearly 8.4%, while the current yield on BB and B bonds is 7.75%. Given the uncertainty surrounding the macroeconomic environment, particularly with issues in Europe still hanging over our heads, we are reluctant to make a precise estimate of returns for 2012 but expect that they ought to be within the 6.5–8.5% range.

### Industry Spotlight: Gaming

Ever since the Resorts Casino Hotel was opened in Atlantic City, NJ, in 1978, locales have competed to draw business away from the only true destination gaming location in the U.S. — Las Vegas. Gaming was introduced in Atlantic City to turn around the once-elegant seaside resort location, which had fallen on hard times and had become a seedy shadow of its former self. While gaming thrived for a while in Atlantic City, it never proved to be a competitive threat to Las Vegas and, in recent years, has faltered as other gaming venues have opened within the broader New York metro region. Municipal officials in change of Atlantic City and New Jersey state officials in charge of gaming activities never have been able to the work together to put the needs of a competitive gaming industry above their own parochial demands. As a result, they squandered the nearly 30 years they had before another gaming venue opened (SugarHouse Casino in Philadelphia) within the immediate vicinity of Atlantic City.

Unfortunately, it appears that officials of other new and/or proposed gaming venues (New York, Ohio, and the Miami area of Florida) are likely to make the same mistake. While gambling is still viewed by some as sinful, elected officials see it as a way to generate revenue without directly taxing their constituents. Rather than asking the question that seems obvious from an investor's perspective (what gaming locations, rules and regulations are likely to maximize the revenues for the state/municipality?), licenses are doled out for political reasons. For example, opening a casino in rural Sullivan County, NY, some two-plus hours northwest of New York City might help revive the crumbling resort industry in the region once known as the Borsht Belt, but it is unlikely to generate as much revenue as granting a license to a gaming company to build a full-scale gaming resort in New York City itself. While international travelers might visit New York City to gamble, shop and eat much as they do in Las Vegas, Singapore and Macau, few are likely to take a bus ride to a Sullivan County casino or even visit one of the

two "racinos" (a casino built at a horse racing track, usually without a hotel and entertainment facilities) built in the outer boroughs of New York City (i.e., areas still in New York City but outside of Manhattan). Unless there are some quick changes in the proposals for casinos in Florida's Dade County, which includes Miami, the elected officials there appear likely to make the same mistake that New York has and New Jersey did years before and authorize casinos that will not be the best draw possible for the region.

It looks like Las Vegas will retain its title as the sole American destination casino resort region where Americans and foreign visitors go to stay, eat, drink, shop, socialize, attend conventions and gamble. Regional locations may succeed and even generate significant returns for investors, but they are unlikely to maximize tax revenues until elected officials start recognizing that the long-term health of their local casino operators is dependent on decisions that maximize the opportunity rather than somehow limiting the "sin". ■

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