WESTERN ASSET

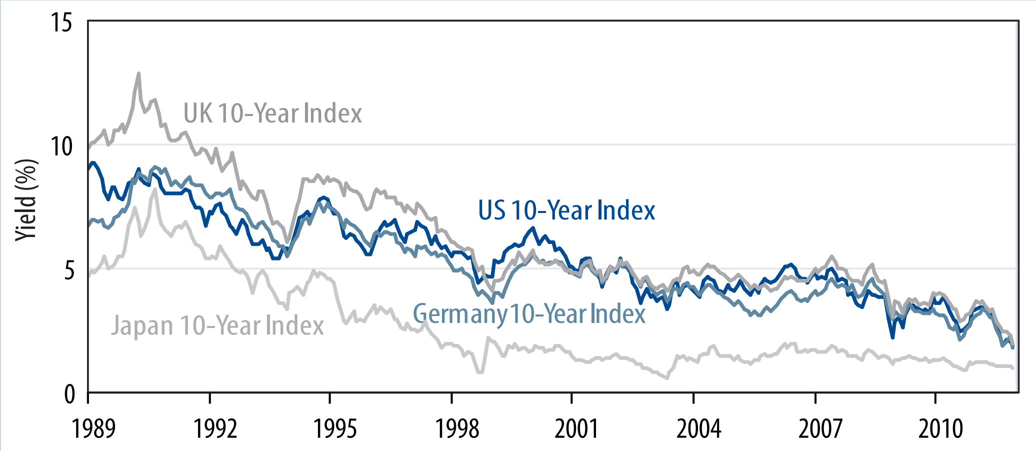
The Importance of Income

Executive Summary

- Based on historical analysis, as well as on current fundamentals and valuations, we believe that investors should consider allocating to high-yielding fixed-income sectors as an equity alternative and an attractive investment opportunity.
- Despite historically low yields in the US Treasury market and related investment-grade sectors, a significant opportunity exists to seek both meaningful income and equity-like total returns over an intermediate to long-term holding period. While correlation to equity investments will be high, the availability and persistence of meaningful income should bolster investment returns and reduce volatility over the life of the investment.
- For those investors who believe in continued slow growth and low interest rates, high-yield fixed-income sectors should be particularly attractive, as default rates should stay at reasonably low levels and income should be of particular value.

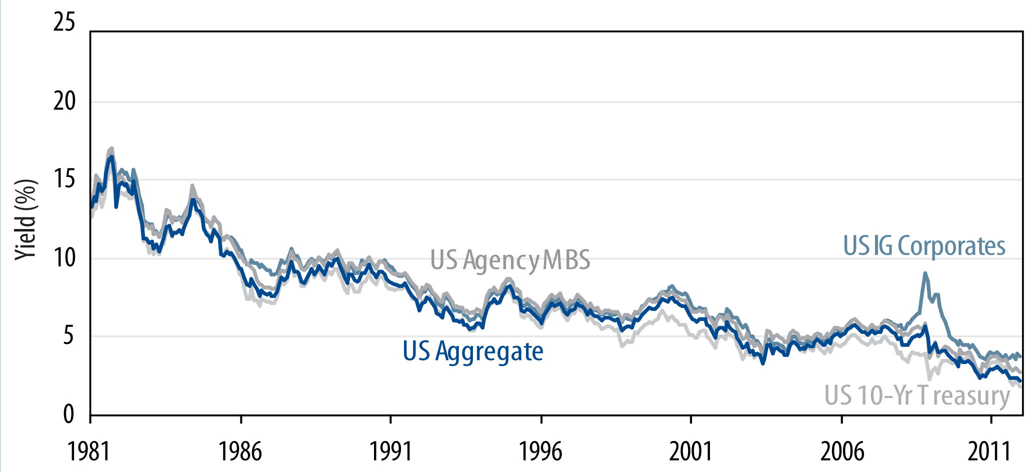
As investors, we know that income is an essential component of total return. Income clearly demonstrates its importance in the fixed-income market, but is also critically important in equities, real estate and currency investing. One of the key issues that investors must confront today is the prospect of receiving significantly less income in the future than they have in the past, primarily due to the efforts of the US Federal Reserve (Fed) to lower most interest rates.

Exhibit 1
Government Bond Yields



Source: Bloomberg. As of 31 Dec 11

Exhibit 2
Benchmark Yields



Source: Barclays Capital. As of 31 Dec 11

It is abundantly clear that yields on US government securities are at or near historic lows and that other investment-grade alternatives, notably corporate bonds and agency MBS, have also approached historic lows. Global alternatives, such as German, UK and Japanese bonds, have also fallen to very low levels in both absolute and historical terms.

The yield on the Barclays Capital U.S. Aggregate Bond Index has declined to 2.24%, with a duration of 4.95, as of December 31, 2011, while the yield on the US Treasury 10-year note ended the year at 1.88%.

So given these low levels of yields, what should an investor expect in terms of returns going forward? The best way to answer this question is to look at the contribution to returns from income historically. Exhibit 3 illustrates historical returns for various fixed-income sectors and the contribution to return from coupon income.

Exhibit 3
US Fixed-Income Coupon/Total Returns (September 30, 1988 – December 30, 2011)

	Coupon Return	Total Return	Annualized Total Return	Percent of Return Attributable to Coupon Income
US HY (Returns, Unhedged)	744.93	740.82	8.96%	101%
US Treasury (Returns, Unhedged)	282.73	400.00	6.12%	71%
US Credit (Returns, Unhedged)	395.85	467.57	6.83%	85%
US MBS (Returns, Unhedged)	374.78	411.33	6.25%	91%

Source: Barclays Capital, Western Asset. Base Currency: USD. As of 30 Dec 11. Longest time series available in Barclays POINT

The most significant contributor to return has been coupon income. In the case of high-yield bonds, more than 100% of the total return achieved since September 1988 has been attributable to coupon income. Even in US Treasury securities, where yields have declined dramatically over the period, 71% of the cumulative return achieved has come from coupon payments. As coupons are a function of yield at issue, we can conclude that the yield offered by an investment will have a significant impact on the total return to be generated by the investment over its life.

As US Treasury yields have fallen below inflation expectations (negative real yields from one to 10 years), long-term investors in this sector will receive less income and take on more risk (higher durations) only to receive less purchasing power in the future. At the same time, the government is in the process of leveraging its balance sheet and worsening what is already a dangerous fiscal imbalance. In addition to low real yields, absolute yield levels are low, suggesting that returns will be significantly lower in the near future than they have been in the recent past.

Are There Alternatives?

Despite low yields in government and related sectors, there exist many opportunities in other fixed-income sectors, including:

- High-yield debt
- Emerging market debt (dollar sovereign, corporate and local currency)
- Bank loans
- Non-agency MBS
- Investment-grade debt of strategically important banks

While these sectors are generally considered to be higher risk, the current risk/reward metrics are favorable. For example, as of year-end, the Barclays Capital U.S. Treasury Index had a yield-to-worst (YTW) of 1.03% versus 8.39% for the Barclays Capital U.S. High-Yield Bond Index. That is an eight-fold yield advantage at a time when the economy is growing, default rates are low and supply is moderate. We also believe that sector fundamentals are strong. Corporations have become increasingly global, have increased their liquidity and have reconstructed their business models to allow for more effective management of costs in the face of economic uncertainty. This is true of both investment-grade and below-investment-grade issuers.

Non-agency MBS is a sector in which fundamentals are weak but future cash flows are reasonably certain. The certainty of these cash flows emanates from the onerous assumptions that are used to derive them. Therefore, current market pricing offers attractive yields and limited downside absent another dramatic downturn in the housing market.

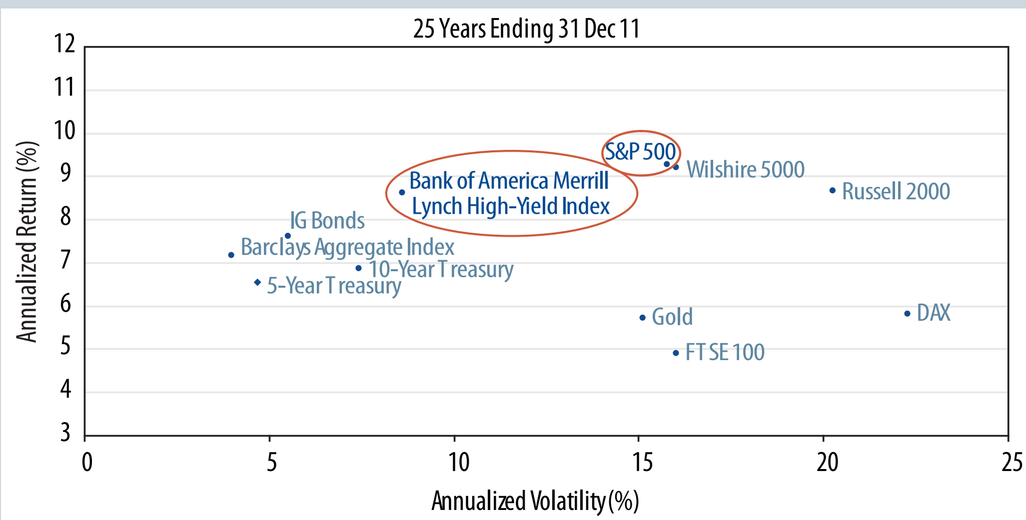
As can be seen in Exhibit 4, these higher-yielding opportunities have had a higher correlation to the US equity market than to US Treasuries (UST) or the Barclays Capital U.S. Aggregate Bond Index. This suggests that these assets, while potentially providing a higher return, are not perfect substitutes for higher-quality bonds.

Exhibit 4
Correlations

	BC Global HY Index	JPMorgan EMBI-Global	S&P/LSTA Performing Loan Index	BC U.S. Treasury	BC U.S. Aggregate Index	S&P 500	Wilshire 5000	Russell 2000	Gold
BC Global HY Index	1.00								
JPMorgan EMBI- Global Composite	0.57	1.00							
S&P/LSTA Performing Loan Index	0.76	0.27	1.00						
BC U.S. Treasury	-0.19	0.09	-0.37	1.00					
BC U.S. Aggregate Index	0.17	0.30	-0.04	0.91	1.00				
S&P 500	0.62	0.58	0.42	-0.23	0.00	1.00			
Wilshire 5000	0.65	0.60	0.44	-0.25	-0.02	0.99	1.00		
Russell 2000	0.64	0.56	0.43	-0.28	-0.07	0.81	0.88	1.00	
Gold	0.10	0.28	-0.01	0.18	0.24	0.01	0.04	0.10	1.00

Source: Barclays Capital, JP Morgan, S&P LSTA, Bloomberg. As of 31 Dec 11

Exhibit 5
Returns and Volatility



Source: JPMorgan, Bloomberg. As of 31 Dec 11

Each investor has to understand his or her own individual objectives for holding bonds. Some investors own bonds to provide liquidity and a safe harbor in turbulent times. Other investors own bonds to provide a diversified source of return.

High-Yield Bonds As a Risk Asset

Given the higher correlation to equities, should high-yield bonds and other high-yielding fixed-income sectors be considered fixed-income or equity? We believe the better question is: "Are high-yield bonds a risk asset or a safe-harbor asset?" For most investors, the answer is that they are risk assets. Given this fact, those investors seeking a safe harbor should not use these sectors as part of their fixed-income allocation, but should include them in their equity allocation. Those who view fixed-income as a return-producing asset have the choice of allocating to these higher-yielding fixed-income sectors as part of their fixed-income, alternative or equity allocations.

Reinvestment of Income

Investors must also analyze the impact of the reinvestment of income on performance. While most investors are willing to accept the fact that high-yield will likely outperform UST over a reasonable holding period, it is the potential volatility and the havoc that negative price movements create that limit investor participation in these sectors. Much like the concept of dollar-cost averaging in the retail space, the high level of income that an investor receives from a sector like high-yield (as a proxy for all of the higher-yielding fixed-income opportunities) can and should be reinvested in the sector. If prices decline, the income received will buy more bonds. Alternatively, if prices rise, the income received will buy fewer bonds. Over time, this will tend to reduce the cost basis of the investments held, minimize the impact of timing, and enhance the total return versus a non-income-producing asset with comparable volatility.

Exhibit 6
Barclays Capital U.S. High-Yield Bond Index Returns (July 1, 1983 – December 31, 2011)

	With Reinvestment	Without Reinvestment
Cumulative	1,171.50%	185.86%
Annualized	8.92%	3.59%

Source: Barclays Capital, Western Asset. As of 31 Dec 11

It is also important to examine when it is best to invest in these sectors. Clearly, an investment in a high-income strategy would have been injurious if one had decided to invest in June 2007. In 2008 and early 2009, spreads on risk-sensitive instruments widened to unprecedented levels, so a June 2007 investment would have resulted in significant draw-downs in net asset values and significant volatility. These potential risks, both in terms of return and volatility, have already been acknowledged. But how would these sectors have performed versus equities? Further, what would the holding-period return have looked like through the end of 2011?

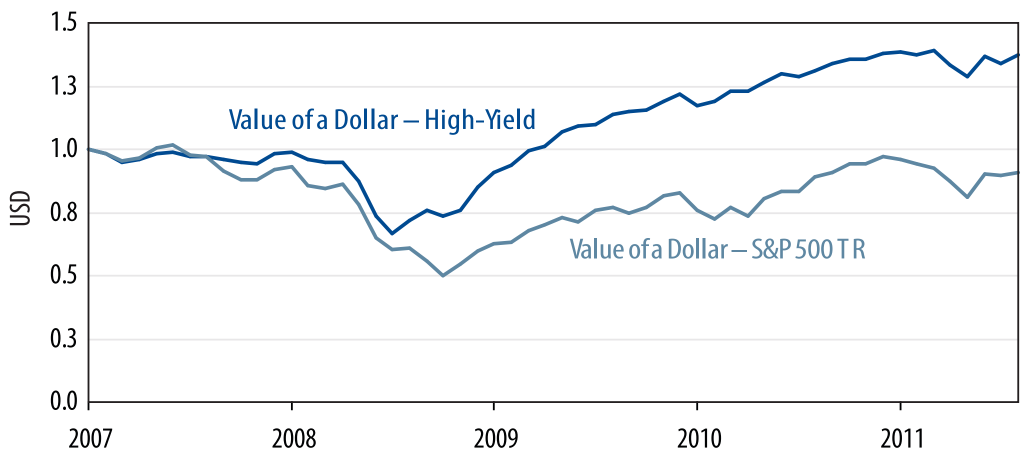
As can be seen in Exhibits 7 and 8, the returns generated for high-yield (again, as a proxy) would have been significantly higher (+7.16%) than the return of the S&P 500 (-2.08%) and would have been decidedly positive despite having been invested immediately before one of the worst performance periods that the high-yield market has ever experienced. It was income that enabled and enhanced these returns over this period for both high-yield and equity despite the enormous and unprecedented level of volatility.

Exhibit 7
High-Yield vs. S&P 500 Total Return Comparison (May 31, 2007 – December 31, 2011)

	Price Return	Income Return	Annualized Total Return
HY:	-8.17%	45.46%	7.16%
S&P TR:	-17.84%	10.51%	-2.08%

Source: Barclays Capital, Morningstar, Western Asset. As of 31 Dec 11

Exhibit 8
High-Yield vs. S&P 500 Total Return (May 31, 2007 – December 31, 2011)

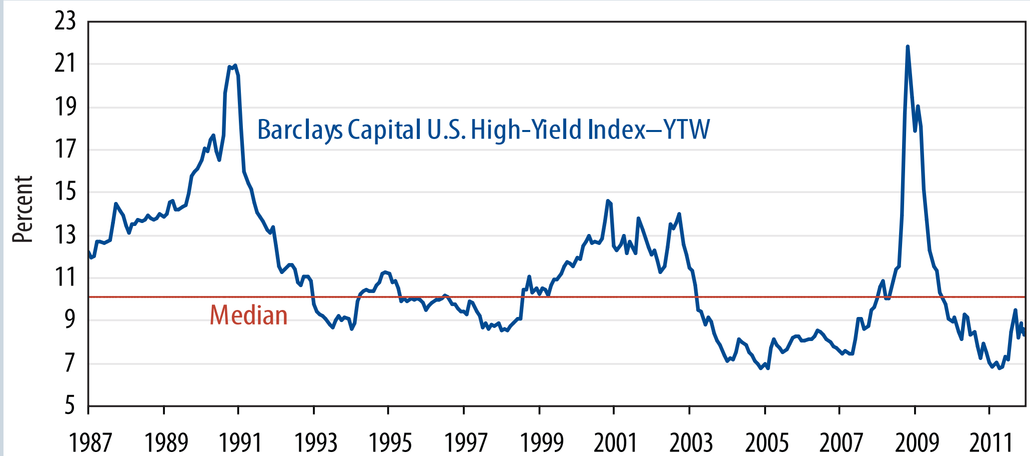


Source: Barclays Capital, Morningstar, Western Asset. As of 31 Dec 11

Relative-Value Opportunity

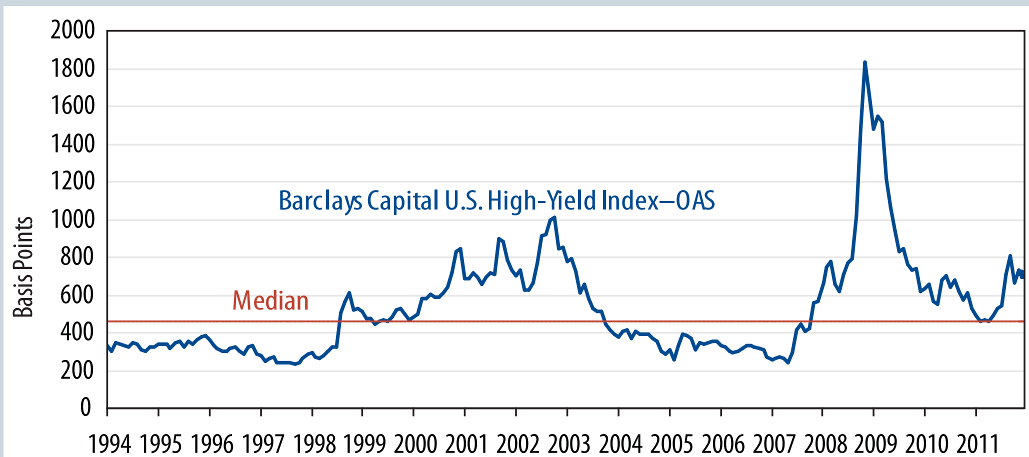
Given past performance in difficult periods, is now a good time to invest in these sectors? The first and most important consideration is: Are fundamentals supportive of these market sectors? We have already cited the general improvement in corporate fundamentals and will provide support for this argument in a separate paper. It is also critical to evaluate market supply and demand. We see strong technicals for many of these higher-yielding fixed-income sectors, as there is likely to be only moderate new supply, a manageable volume of maturities, and strong demand from mutual funds and institutional investors.

Exhibit 9
High-Yield Historical Yield-to-Worst



Source: Barclays Capital. As of 31 Dec 11. Since index inception

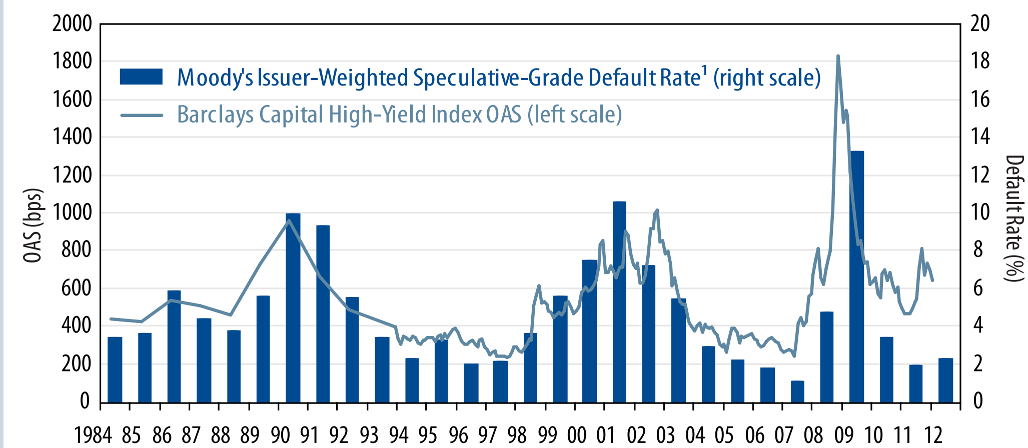
Exhibit 10
High-Yield Historical Option-Adjusted Spread (OAS)



Source: Barclays Capital. As of 31 Dec 11. Longest time series available in Barclays Live

As can be seen in Exhibits 9 and 10, yields are only slightly below the historical median, while spreads are higher. Moreover, default rates are currently below the long-term average (Exhibit 11) while recovery rates have been consistent. Forecasts for default rates by major rating agencies over the next 12 months remain lower than the long-term average, suggesting that holding-period returns may have some favorable tailwinds.

Exhibit 11
Spread and Default Rate Correlation



Source: Moody's, Barclays Capital, Western Asset. As of 31 Jan 12
[1]Moody's Issuer-Weighted Speculative-Grade Default Rate as of 31 Jan 12

This supports the relative-value argument, demonstrating that below-investment-grade bonds are currently offering yields that are well above investment-grade alternatives and that key metrics, such as yield and defaults, have been consistent with or better than long-term levels. It is also important to consider the expected return—defined here as yield (8.36%, as of December 31, 2011) minus loss rates (2.7% default rate with a 40% recovery rate -1.62%) = 6.74%—versus anticipated equity returns. For those who expect that equity returns will be consistent with long-term averages (10% per annum) or higher, this may not represent a compelling equity alternative. For those who expect somewhat subdued equity performance (below 10%), this likely will be viewed as a compelling alternative.

For those investors who are concerned with the potential for rising interest rates, it is important to note that these higher-yielding sectors have performed reasonably well in periods of rising interest rates. This is partially explained by tightening spreads in the face of improved economic conditions, but it is also important to note that a high level of income provided much of the return during these periods, which are generally perceived to be negative for fixed-income.

Exhibit 12
Subsector Performance in a Rising Rate Environment

12-Month Ending	10-Year Treasury Yield Move	High-Yield Bonds Total Return	Emerging Markets Total Return	Bank Loan Total Return
September 87	+220 bps	5.79%	n/a	n/a
February 89	+117 bps	7.32%	n/a	n/a
December 94	+204 bps	1.57%	-18.35%	n/a
December 99	+179 bps	3.38%	24.18%	3.58%
May 04	+130 bps	13.23%	3.14%	7.47%
June 06	+120 bps	4.94%	4.63%	6.16%

Source: JPMorgan. As of 31 Dec 11

Conclusions

Based on historical analysis, as well as current fundamentals and valuations, we believe that investors should consider allocating to high-yielding fixed-income sectors as an equity alternative and an attractive investment opportunity. Despite historically low yields in the US Treasury market and related investment-grade sectors, a significant opportunity exists to seek both meaningful income and equity-like total returns over an intermediate to long-term holding period. While correlation to equity investments will be high, the availability and persistence of meaningful income should bolster investment returns and reduce volatility over the life of the investment.

For those investors who believe in continued slow growth and low interest rates, high-yield fixed-income sectors should be particularly attractive, as default rates should stay at reasonably low levels and income should be of particular value.

Last, for those who are concerned about rising rates, these high-yielding sectors of the market have demonstrated the ability to provide positive total returns during such periods.