

High-Yield Investing and Your Portfolio Strategy

If you're comparing fixed-income investments, it can be extremely tempting to focus on securities or mutual funds that offer the highest yields. But it's a strategy that can backfire, because unusually high yields may come at the price of higher risk. Instead, T. Rowe Price advocates a more holistic approach: Identify the needs of your overall portfolio first, then consider whether high-yield investing can play a productive role in that strategy.

To make that choice, however, you'll need to know a little more about what kinds of bonds carry high yields and how those bonds behave. You'll also need to bear in mind a few unique characteristics that could have an effect on what kinds of higher-yielding bonds will suit your needs.

Finding higher yields and understanding the risks

Higher yields are generally found among the following types of bonds:

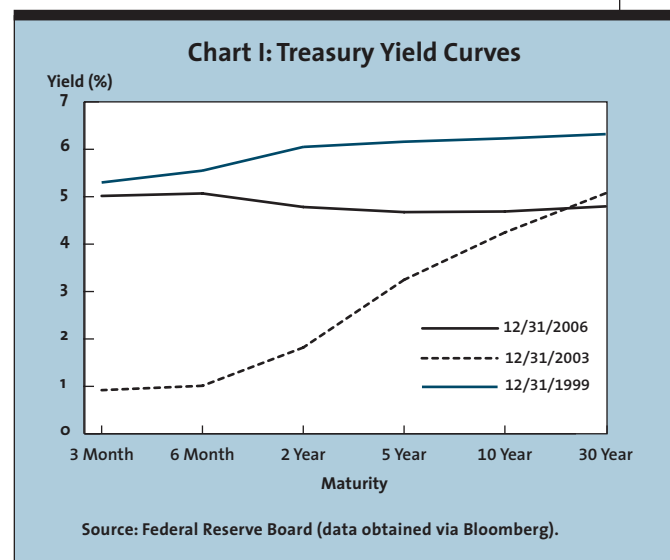
1. Those with long maturities
2. Those of lower credit quality
3. Those issued outside the U.S.

■ *Long-maturity bonds*—Long-term interest rates are typically higher than short-term rates because investors demand higher compensation for committing their capital for an extended period of time and as protection from the erosion of value caused by inflation.

The relationship between yield and maturity for a particular bond market sector, such as Treasury bonds, is shown by its yield curve. Normally, the yield curve slopes upward from

left to right because long-term rates are higher than short-term rates. Other possibilities are flat, and even inverted, yield curves.

Chart I shows yield curve “snapshots” taken at several dates in the past decade. The curve from year-end 2003 shows a relatively steep curve, while the one from 1999 is more flat. The curve from 2006 is inverted, with short-term yields exceeding their long-term counterparts. You may want to check the yield curve before investing to see if bonds with longer maturities will indeed provide higher yields.



Bonds with long maturities also pose an interest rate risk. Since bond prices and interest rates move in opposite directions, you face the possibility of a decrease in your bond's value if interest rates rise after you invest in a fixed-income security.

When rates move higher or lower, values of long-maturity bonds fluctuate more than

those of shorter maturities. This means interest rate risk increases with maturity. So if you invest in long-term bonds for higher yield, you may be taking on considerable interest rate risk. However, if you expect to hold a bond until maturity (when the principal is repaid), or if you can remain invested in a bond fund for several years, short-term interest rate risk may be less of a concern.

Chart II: The Effect of Interest Rate Changes on Bond Prices

Bond maturity in years	Rates fall one percentage point and the bond's value rises to:	Rates rise one percentage point and the bond's value drops to:
1	\$1,009.62	\$990.57
3	\$1,027.75	\$973.27
5	\$1,044.52	\$957.88
10	\$1,081.11	\$926.40
30	\$1,172.92	\$862.35

This chart assumes a 5% coupon and \$1,000 par value for each bond and shows value changes apart from fluctuations caused by other market conditions or factors. This chart is for illustrative purposes only and does not represent an investment in any specific security.

You can estimate interest rate risk by checking the duration of an investment. Duration measures a bond's sensitivity to interest rate fluctuations more accurately than maturity. It tells you how much a bond's price will change for each percentage point change in interest rates. For example, the price of a bond with a five-year duration will drop about 5% if rates rise by one percentage point, and vice versa. Lower duration indicates lower market risk but does not address another important consideration—potential credit risk.

■ *Lower-quality (high-yield) bonds*—In general, lower-quality bonds must offer higher yields to attract investors because they pose a greater credit risk. If a bond issuer's finances were to weaken, it could lead to a credit downgrade or default that would cause a bond's price to fall. In case of default, the company may not make interest payments and principal could be lost.

While most bond investments outside Treasuries entail some degree of credit risk, high-yield corporate bonds are the riskiest. Their performance, much like stocks,

is typically more closely tied to the issuer's financial status and the economy's overall health than to interest rate fluctuations.

Another factor to consider with lower-quality bonds is liquidity risk. Liquidity—the ability to sell your investment quickly at a reasonable price—can deteriorate quickly if the market goes into a sharp or extended downturn. This could mean that fewer people would be interested in high-yield bonds, so the bond holder might have to drop the price to find a buyer.

To help investors assess risk, several rating agencies, such as Moody's Investor Services and Standard & Poor's, assign letter ratings to bonds after analyzing the issuer's financial situation (some issuers choose not to be rated). Bonds with any of the four highest ratings are considered investment grade; those with lower ratings are considered noninvestment grade, often called “high-yield” or “junk” bonds.

Table I: Moody's and Standard & Poor's Rating Codes

These rating systems are similar, although not identical.

Moody's	S&P	Meaning
Aaa	AAA	Highest-quality bonds. Issuers are considered extremely stable and dependable.
Aa	AA	High-quality bonds. Long-term investment risk is slightly higher than on AAA bonds.
A	A	Bonds with many favorable investment attributes.
Baa	BBB	Medium-grade bonds. Quality is adequate at present, but long-term stability may be doubtful.
Ba B	BB B	Bonds with a speculative element. Security of payments is not well safeguarded.
Caa Ca C	CCC CC C	Bonds are extremely speculative. The danger of a default is high.
—	D	In default.

■ *Foreign bonds*—Higher bond yields may be found in developed countries that are in a different phase of the economic cycle than the U.S. In less-developed emerging markets, bond yields are likely to be higher because of greater credit risk.

Investing in foreign bonds that are not denominated in U.S. dollars involves the additional element of currency risk—the possibility that the U.S. dollar may rise in value against other currencies. A rising dollar reduces the value of foreign investments when converted into dollars, while a weaker dollar has a favorable effect. For example, if a U.S. investor buys a British bond yielding 8% and the dollar strengthens 5% against the British pound during the year, the investor's total return for the year (assuming no price change) is reduced to 3%. If the dollar weakened 5% instead, the total return would be 13%.

■ *Mortgage-backed securities*—Mortgage-backed securities offer yields that are potentially higher than Treasuries without much additional credit risk. Ginnie Maes (GNMAs), for example, are created by the Government National Mortgage Association and are backed by the full faith and credit of the U.S. government. Their yields are higher than comparable Treasuries because the possibility that homeowners will prepay their mortgages makes their maturities uncertain. Because prepayments typically increase when interest rates decline, mortgage-backed securities may underperform Treasuries when rates fall.

Fitting high-yield securities into your portfolio

Before making any investment decision, you need to evaluate your overall financial picture and long-term objectives. To build a portfolio that works for you, we suggest you identify your goals and time horizon and then determine an appropriate asset allocation.

High-yield securities may be an appropriate part of the fixed-income portion of a diversified investment portfolio. For example, Chart III shows that high-yield bonds might represent 20% of the fixed-income portion of a portfolio. (Note that the amount of your portfolio you should have in fixed income will vary depending on your time horizon; visit troweprice.com for more information.)

Chart III: Suggested Portfolio Diversification—Fixed Income



Assembling a portfolio of individual bonds can be time-consuming and costly. For instant diversification, you may want to consider the convenience of bond mutual funds. Other benefits include professional management of investment risks, credit analysis, a high degree of liquidity, and low investment minimums—making them a practical way to invest for higher yield without taking excessive risks.

Before selecting an investment, you should take one more step: Determine whether tax-free municipal bonds would be more advantageous to you than taxable bonds. The answer hinges on a comparison of pretax and after-tax yields. Because municipal bonds provide federal tax-free income, their yields are almost always lower than on comparable taxable issues, but they might actually be higher for you on an after-tax basis. To find how much a taxable bond would have to yield to equal a particular tax-free yield, simply divide the yield of the tax-free investment by the quantity of 1.00 minus your federal tax rate. For example, if a tax-free bond yields 5% and you are in the 25% bracket, divide 5 by .75 (1.00 – .25). The result, 6.67%, means that a taxable bond would have to yield more than 6.67% to be more advantageous for you.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

