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High Yield Bonds – Too Fast, Too Furious

High yield risk premiums have dropped more than 1,100 bps (“bps”=1/100th of 1%) from their record levels in mid-December and are now slightly below their peak levels seen during the past two recessions (see chart below). Because we are likely in the later innings of this Great Recession, we believe that it is appropriate to view the world through a more normal recessionary lens. The run-up in high yield prices (as risk premiums collapsed) since early-March produced a 32% return, on par with the S&P 500’s 36% gain. We believe that the high yield rally is likely to stall in the near term, until we get more clarity about the path of economic growth and default rates. During this consolidation period, we believe that the higher-rated tiers of the high yield market are likely to outperform the lower-rated tiers. We will likely maintain our neutral tactical weighting to the high yield sector, but will look for opportunities to upgrade the average credit quality of our holdings.

High Yield Risk Premiums

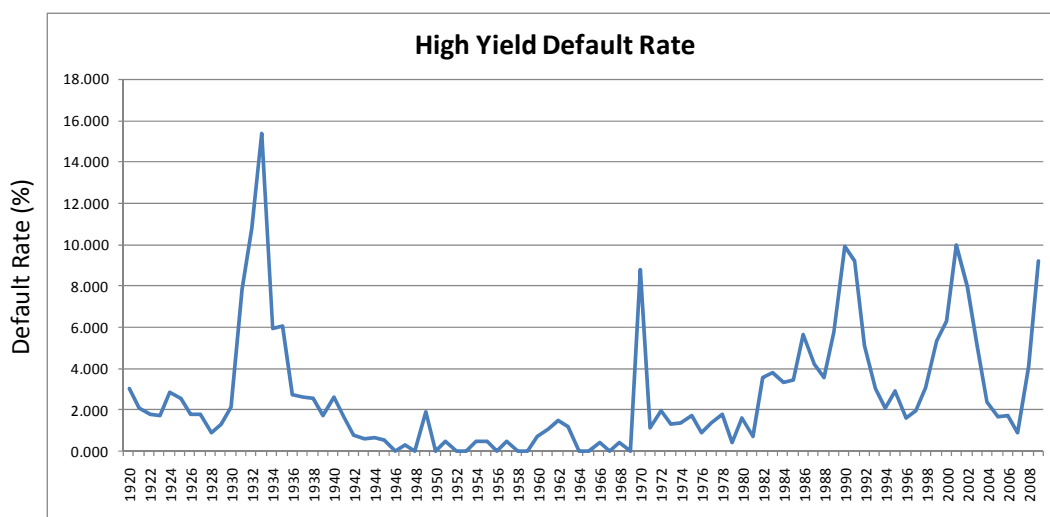


Source: *Merrill Lynch*

The collapse in risk premiums was justified in our view, but the move may have been too much too soon, especially for the lowest rated tier of the market. The decline in risk premiums was supported by the following:

1. Economic “green shoots,” as economic data became less bad.
2. Stabilization of the financial system after the bank stress tests.
3. Strong inflows into the sector from institutional and retail investors. AMG Data Services reports that flows into high yield mutual funds have been positive for 14 straight weeks, and they have attracted more than \$7.3 billion since mid-March.
4. Renewed access to the capital markets for high yield issuers, after having been shut out of the market since mid-2008. This will likely help issuers refinance their maturing debt.

These positive developments will probably cause high yield default rates to be less onerous than we (and the market) originally anticipated. The chart below shows that the default rate hit a high of almost 16% during the Great Depression in 1933 and peaked around 10% during the past two recessions. The default rate is still accelerating and has risen to 9.2% as of the end of May, up from 1.9% just a year ago. *Past performance is no guarantee of future results.*



Source: Moody's

Given the severity of the current recession and the virtual shut-down in the financial markets during the second half of 2008 into the first quarter of 2009, the market had anticipated (as did Riverfront) that defaults could exceed those seen during the Great Depression. The table below shows Riverfront's and Moody's original estimates for peak defaults in pessimistic ("Unlucky"), baseline, and optimistic ("Lucky") scenarios. We now believe that default rates are likely to peak near/slightly above our "Lucky" line estimate, barring an unexpected double-dip recession or re-freezing of the capital markets.

Peak Default Estimates					
Riverfront	Original	Most Recent	Moody's	Original	Most Recent
Unlucky	28.8%		Pessimistic	20.6%	
Baseline	21.5%		Baseline	16.4%	13.8%
Lucky	13%	X	Optimistic	15.6%	

However, the market has already anticipated a lower level of defaults and the contraction in risk premiums is likely to moderate until the market gets more clarity on the path of economic growth and defaults. Risk premiums generally rise sharply during recessionary periods in order to compensate investors for an expected increase in credit losses due to increased defaults and lower recovery values. In the past two recessions, risk premiums peaked about the same time that default rates did, and the default rate is currently still accelerating. We believe that risk premiums overshot sharply on the upside for the reasons previously mentioned, and could have overshot slightly on the downside. While we do not expect spreads to come anywhere close to re-testing their previous highs, we could see spreads widen in the near term, especially in the lowest rated (CCC) tier. In our view, defaults will likely be concentrated in the CCC-rated sector; our expected peak defaults reach 35% in our Lucky scenario.

The table below shows the current and historical risk premiums for various quality segments of the high yield market. Risk premiums (spreads) for the lower quality segments of the high yield market (B/CCC-rated) are now significantly (150 to 776 bps) lower than their peak levels during the last recession, while risk premiums on "higher quality junk" (BB-rated) are still slightly (19 bps) higher.

High Yield	Yield	Risk Premiums (bps)				Avg.*	Current – Avg.	
		High	6/19/09	Change	Peak Last Recession			Current–Last Recession
Index	13.47%	2182	1075	(1107)	1120	(45)	586	489
BB	10.45%	1468	760	(708)	741	19	373	387
B	12.39%	2084	957	(1127)	1107	(150)	577	380
CCC	20.35%	4429	1802	(2627)	2578	(776)	1258	544

Source: Merrill Lynch *Since 12/31/96

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S&P Ratings Definitions

Obligations rated BB, B, CCC, CC, and C are regarded as having significant speculative characteristics. BB indicates the least degree of speculation and C the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.

- BB** An obligation rated BB is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
- B** An obligation rated B is more vulnerable to nonpayment than obligations rated BB, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
- CCC** An obligation rated CCC is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

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