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**BIG PICTURE...**

## BB versus B: Can the Recent Trend Continue?

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Varying the quality mix over time is one of the key strategies available to active high yield managers at a level more aggregated than individual security selection. **Exhibit 1** documents substantial total return differentials between the Double-B and Single-B segments<sup>1</sup> in certain years. The largest of those total return differentials (in favor of either Double-Bs or Single-Bs) are clustered around the peak default years of the past two cycles, 1991 and 2001. Over the past two years of more modest default rates, by contrast, portfolio managers derived minimal advantage from correctly predicting the relative performance of the two rating subcategories.

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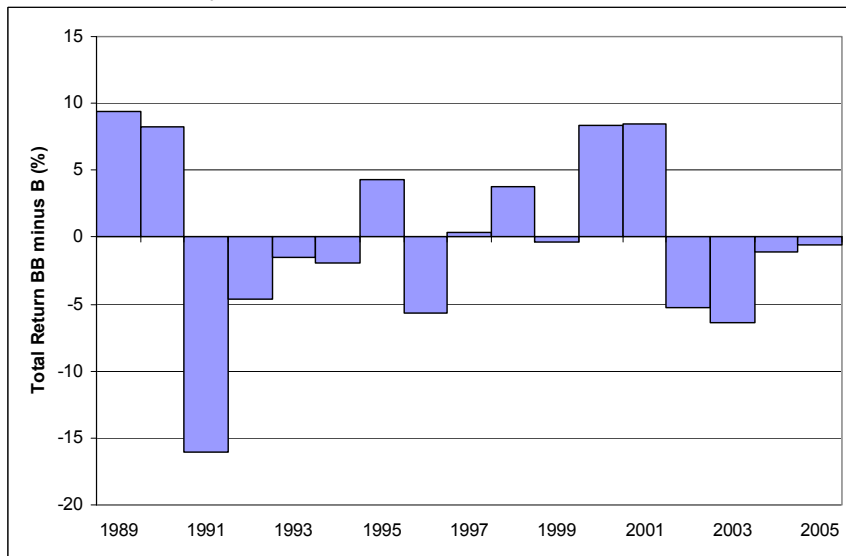
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**Exhibit 1: BB minus B Total Return Differential 1989-2005, Annually**



Source: Merrill Lynch & Co.

<sup>1</sup> Our analysis focuses on the two top tiers of the speculative grade universe, as nondistressed high yield managers' investment guidelines tend to constrain their holdings of Triple-C paper. In addition, the comparatively small and volatile Triple-C segment is noisy, making it difficult to obtain statistically valid results involving that rating tier. Finally, the dispersion of returns within the Triple-C category is quite high, resulting in a sizable risk of calling the sector correctly but transacting in specific issues that fail to produce the desired result.

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*The last time Single-Bs outperformed this dramatically in a low-default-rate environment, they received a big handicap from the beginning Double-B/Single-B spread*

In light of these facts, it is somewhat surprising that Single-Bs have outperformed Double-Bs dramatically during 2006. Moody's global issuer-based default rate measured just 1.65% in the 12 months ending March 31, 2006, well below the 1970-2005 mean annual rate of 3.85%, but from January 1 through May 4, 2006, the Single-B segment of Merrill Lynch's High Yield Master Index<sup>2</sup> beat the Double-B segment, 3.79% to 1.98%.

If relative performance were to persist at that rate through year-end, Single-Bs would prevail by a margin of 545 basis points (11.46% versus 6.01%). That would nearly match the biggest-ever gap in a low-default rate period, 569 basis points in 1996. The Single-Bs' 1996 return edge, moreover, was helped by an unusually large Double-B/Single-B yield spread at the beginning-of-year. At 254 basis points, the spread exceeded the 1989-2006 mean<sup>3</sup> of 219 basis points and was the fourth largest spread of the 18-year period. By contrast, the Double-B/Single-B spread at the beginning of 2006 was a mere 64 basis points.<sup>4</sup> As a final point, no dramatic escalation in the default rate during the remainder of 2006 is likely to reinforce the unusually strong relative performance of Single-Bs. Moody's Investors Service projects a rise in the default rate to only 2.1% through year-end.

In summary, there are good reasons to question the sustainability of the Single-B sector's year-to-date total return advantage. Instead of chasing relative performance, it might now be advisable for portfolio managers to upgrade, at the margin, from Single-Bs to Double-Bs.<sup>5</sup>

### Analysis

To address this question in a rigorous fashion, we must understand what actually drives the magnitude of the Double-B/Single-B total return differential. In this study, we were not concerned with the sign, that is, whether Single-Bs outperformed Double-Bs or vice versa. Rather, our objective was to establish why allocation between the two sectors has a big impact on the portfolio-wide return in some years, but not in others.

**Exhibit 2** corroborates the inference we made from Exhibit 1. Double-B and Single-B returns tend to be similar when the default rate is low and to differ greatly when default rates are high. The correlation (R) between the two time series reflected in the graph is 75.27%.

## LEVERAGE WORLD

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<sup>2</sup> We use Merrill Lynch's cash-pay-only high yield index in this study, in order to benefit from a longer history of rating-category returns than is available for the cash-pay-plus-zero-coupon-and-pay-in-kind Master II. The choice should not significantly affect our conclusions. For instance, readers can compare the year-to-date Single-B and Double-B total returns cited in the text with the comparable figures for the rating subindexes of the Master II – 1.98% and 11.56%.

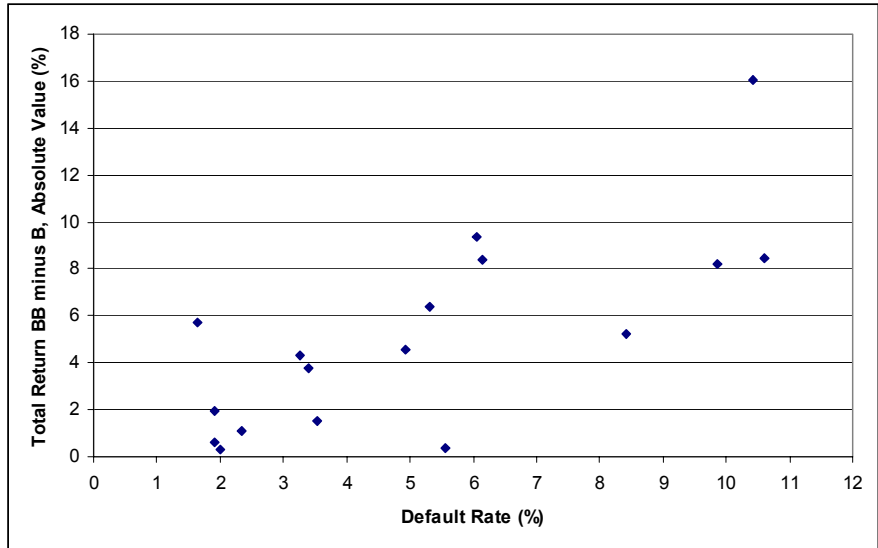
<sup>3</sup> Measured at the preceding year's close.

<sup>4</sup> This figure may be understated because of the large impact of General Motors Acceptance Corp. on the Double-B subindex, but the differential between the rating subindexes of Merrill Lynch's U.S. High Yield Constrained Index was also narrow by historical standards – 122 basis points versus an annual mean since inception in 1996 of 2000.

<sup>5</sup> Note that this analysis focuses on a longer investment horizon than the Credit Rating Value Tracker on page 22. Another difference is that the present study focuses on quality groups defined by actual ratings, rather than according to senior-equivalent ratings.

*The magnitude of the Double-B/Single-B spread differential is correlated with default rates...*

**Exhibit 2: BB minus B Total Return Differential versus Default Rate**  
1989-2005, Annually

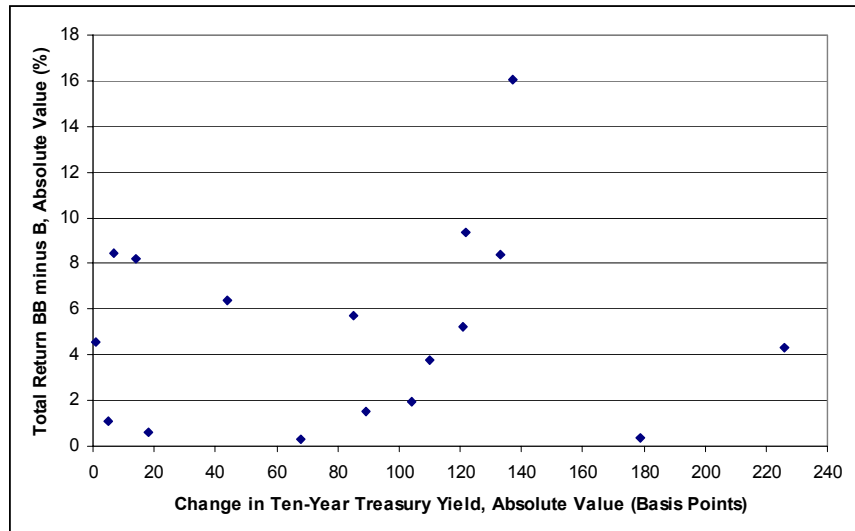


Source: Merrill Lynch & Co.

Some practitioners emphasize the role of interest rates, based on the longer duration of the lower-yielding and longer-dated Double-Bs. Currently, Merrill Lynch index data show Macaulay durations of 5.51 for the Double-B subindex and 5.30 for the Single-B subindex. If the difference is material, we should expect to find that when interest rates moved sharply (either up or down), Double-Bs and Single-Bs performed very differently. **Exhibit 3** shows no such consistent pattern, however. With the exception of one outlier,<sup>6</sup> the graph shows a flattish trend line. The correlation between rate changes and total return differentials is a negligible 2.76%.

*...but not with interest rate volatility.*

**Exhibit 3: BB minus B Total Return Differential versus Change in Treasury Yield**  
1989-2005, Annually

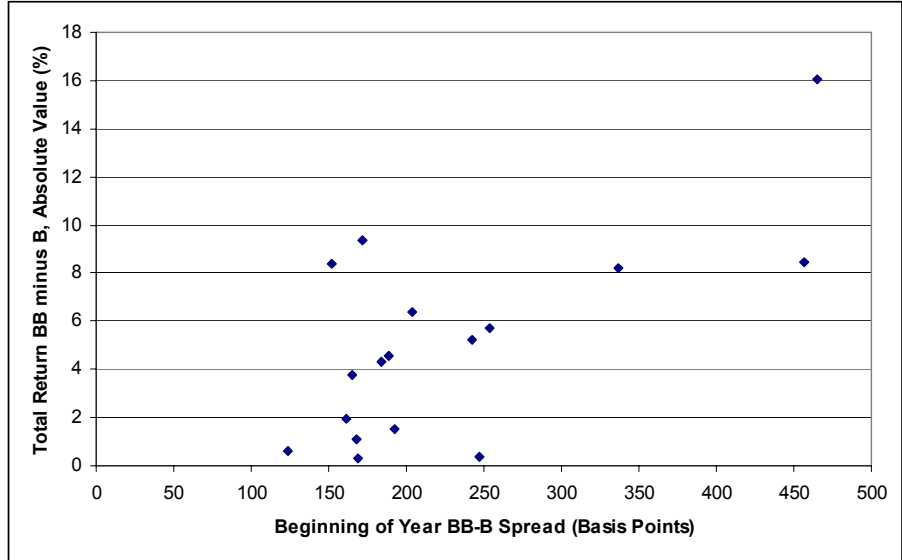


Source: Merrill Lynch & Co.

<sup>6</sup> In 1991, the ten-year Treasury yield changed by an above-average amount, 137 basis points, and the Double-B/Single-B total return differential was far greater than in any other year, at 1,605 basis points. Note, however, that the sign of the return differential was contrary to hypothesis, that is, the shorter-duration Single-Bs outperformed the longer-duration Double-Bs as Treasury yields declined.

**Exhibit 4** confirms our hypothesized connection between the beginning-of-year Double-B/Single-B spread and the magnitude of the total return differential for the year. The graph shows a clearly rising trend line; wide beginning spreads are associated with large disparities in the total returns of the two rating subcategories. Correlation measures 68.08%.

**Exhibit 4: BB minus B Total Return Differential versus Beginning of Year BB minus B Spread**  
1989-2005, Annually



Source: Merrill Lynch & Co.

*When Double-Bs and Single-Bs start the year at similar yields, they tend to perform similarly*

Based on these findings, we can attempt to maximize our ability to explain the variance in annual Double-B/Single-B total return differentials by creating a multivariate model. We select the two variables with high individual explanatory power, default rate and beginning-of-year spread.

As frequently happens in such exercises, the latter variable does not stand up well in a multivariable context. Two measures, the t-Statistic and P-value, indicate that beginning-of-year spread should be rejected.

*Beginning-of-year spread does not make the cut for our final model*

This proves no great loss, however. The explanatory power ( $R^2$ ) of the two-variable model, at 58.24%, is not much higher than that of the surviving variable (default rate) alone, at 56.66%. A regression model using the default rate as its single explanatory variable is statistically robust, with a t-Statistic of 4.43 and a P-value of 0.0005. The standard error of the default rate variable is 0.23. We proceed with our analysis using this univariate model.

The linear regression formula generated by our model is:

$$y = -0.14 + 1.02x$$

Where:

$$y = \text{Double-B total return minus Single-B total return}$$

$$x = \text{annual default rate.}$$

Plugging in the numbers, we find that based on Moody's projected full-year default rate of 2.1%, we would expect a 2006 Double-B/Single-B total return differential with an absolute value of exactly 200 basis points (that is, either +200 or -200). To give the Single-B sector the benefit of the doubt, let us increase that figure by one standard error, to 223 basis points.

For the completed portion of the year (January 1 through May 4), Single-Bs outperformed Double-Bs by 545 basis points (annualized). To match the full-year predicted differential *plus one standard error* of 223 basis points, the annualized differential for the remaining two-thirds of the year (May 5 through December 31) would have to equal  $n$  in the following equation:

$$(.34 \times 545) + (.66 \times n) = 223$$

Solving for  $n$  gives us a predicted annualized total return advantage of 57.1 basis points for Single-Bs for the final 7.9 months of 2006. That equates to 37.7 basis points in nonannualized terms. Based on the key factor that historically has driven the magnitude of the Double-B/Single-B total return differential, we should expect the performance edge to shrink drastically over the balance of 2006.

***History suggests that Single-Bs will not maintain their year-to-date total return margin***

#### ***Conclusion***

Through May 4, Single-Bs have outperformed Double-Bs by far more than the margin they are likely to maintain for the balance of the year, based on the key determinant of the prevailing default environment. A comparable anomaly lasted the entire year in 1996, but Single-Bs had the advantage in that year of an above-average beginning-of-year yield spread over Double-Bs. This factor, which is relevant on a stand-alone basis, does not apply in 2006.

It is possible that tight supplies will persist throughout the year, pushing high yield investors to bid up lesser-quality paper in order to stay fully invested. If no adverse shock intensifies investors' risk aversion during the period, Single-Bs could continue to outperform Double-Bs by an anomalously large margin.

In the high yield market, however, shocks are the norm, rather than the exception. If shocks were rare, total return would tend to approximate the index's beginning-of-the-year yield (which reflects already-available information bearing on interest rates and default risk). That is not what experience shows, however. In only six out of 21 years since the high yield index's inception has total return come within 100 basis points in either direction of the beginning yield. Therefore, although anything is possible, an investor who expects Single-Bs to maintain their year-to-date annualized total return advantage through December 31 is betting heavily against the evidence of past market cycles.

A second key finding of our study is that contrary to received wisdom, the total return differential between Double-Bs and Single-Bs is not a function of interest rate volatility (as measured by changes in ten-year Treasury yields), despite the duration difference between the two rating groups.

**LW**

***The odds are against Single-Bs enjoying the benefit of stable conditions***

## Europe versus U.S. — High Yield Spread

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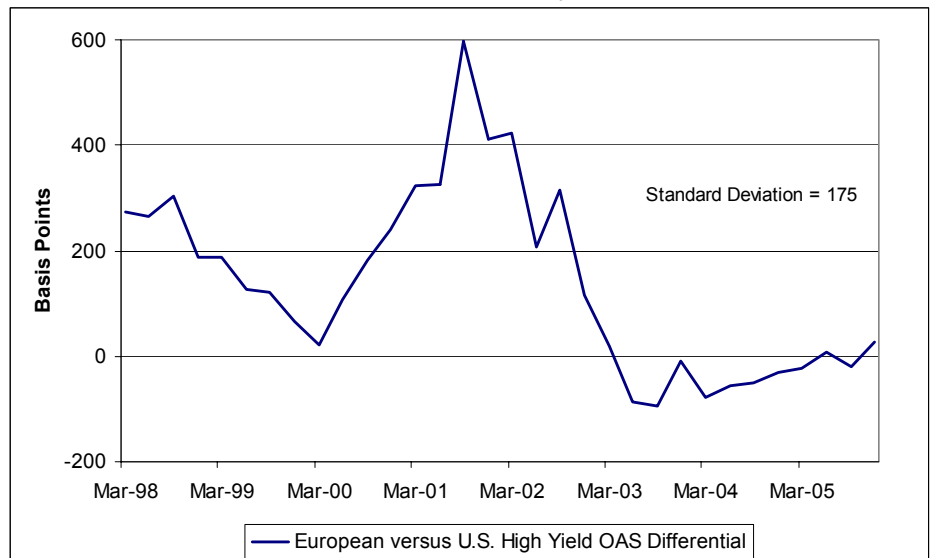
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*Judging by historical average spreads, the European high yield sector is currently extremely rich versus its U.S. counterpart. That is not the only way to judge the matter, however.*

The European high yield sector currently looks very rich versus its U.S. counterpart, at least according to conventional spread analysis. **Exhibit 1** shows the historical relationship between the option-adjusted spread (OAS) of the Merrill Lynch European High Yield Index<sup>1</sup> and of the U.S.-based High Yield Master II Index,<sup>2</sup> from the former's inception on December 31, 1997 through December 31, 2005. Over that historical period, the mean differential was +138 basis points, with a standard deviation of 175 basis points. On May 4, 2006, the spread was 18 basis points, representing an extreme of 0.89 standard deviations on the narrow side. (See **Exhibit 2**.)

### Exhibit 1: European versus U.S. High Yield Option-Adjusted Spread Differential

December 31, 1997 to December 31, 2005, Quarterly



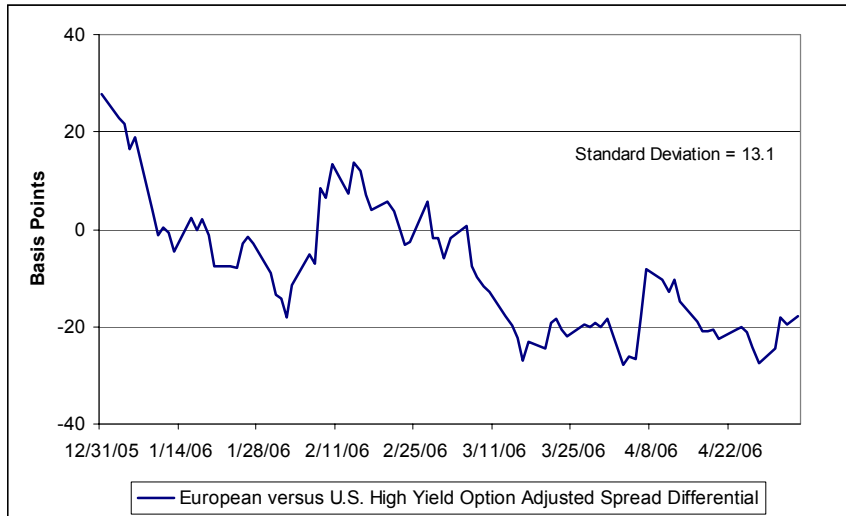
Source: Merrill Lynch & Co.

Following the traditional “average spread” logic, some investors would be inclined to reduce their European and increase their U.S. high yield exposure. Such reasoning is not unfounded. Judging by the historical fluctuations of the fever line in Exhibit 1, it appears highly probable that the current yield giveup into Europe will swing to a yield pickup at some point. In fancier terms, it is rational for investors to rely on reversion to the mean — the only question being how long the reversion will take.

<sup>1</sup> Ticker: HE00.

<sup>2</sup> Ticker: H0A0.

**Exhibit 2: European versus U.S. High Yield Option-Adjusted Spread Differential**  
December 31, 2005 to May 4, 2006, Daily



Source: Merrill Lynch & Co.

*“Narrower than average” does not necessarily mean “too narrow”*

This is quite different, however, from saying that European high yield debt is fundamentally rich versus U.S. high yield debt. A divergence from the average OAS differential does not automatically indicate that one region is overpriced relative to the other. That would be true only if the current risk differential between the two regions always equaled the average risk differential. When the risk of European speculative grade debt declines relative to the risk of U.S. speculative grade debt, the difference in risk premiums *should* narrow.

**Analysis**

To be sure, quantifying the relative risk of the European and U.S. high yield sectors is no simple task. **Exhibit 3** sheds some light on the question, however.

**Exhibit 3: Macro Tracker Variables U.S. versus Europe**  
April 30, 2006 - (%)

| Variable (Sign of Correlation) | Europe | Germany | UK    | France | Italy | U.S.  | Advantage To |
|--------------------------------|--------|---------|-------|--------|-------|-------|--------------|
| Default Rate (+)               | 0.00   | -       | -     | -      | -     | 2.26  | Europe       |
| Δ CPI (+)                      | -      | 1.77    | 1.81  | 1.71   | 2.09  | 3.42  | Europe       |
| Yield Curve (-)                | -      | 1.26    | 0.22  | 1.37   | 1.66  | 0.33  | Europe       |
| Δ Unemployment Rate (+)        | -      | -5.04   | 11.11 | -5.94  | -2.53 | -7.84 | U.S.         |
| Δ Industrial Production (-)    | -      | 6.42    | -1.41 | -0.59  | 3.32  | 3.63  | U.S.         |

Δ=Change (Year-over-Year)

Sources: Bloomberg, Merrill Lynch & Co., Moody’s Investors Service.

***The current disparity in regional default rates upholds a narrow Europe-to-U.S. spread***

***At present, the U.S. enjoys the edge in economic performance***

As detailed in the Macro Tracker section of *Leverage World* (see page 23 of this issue), certain financial and economic data series are strongly correlated with the U.S. risk premium.<sup>3</sup> It is beyond the scope of the present study to determine the extent to which the same indicators explain variance in the European high yield index's OAS. Nevertheless, it is noteworthy that by some measures, the risk for high yield investors is currently lower in Europe than in the U.S.

Among the variables known to correlate with high yield risk premiums, the speculative grade default rate has the highest explanatory power. Over the past 12 months, Moody's has reported a 0.00% rate for Europe and a 2.26% rate for the United States. The direction of the gap is consistent with the present, narrower-than-average differential between the European and U.S. risk premiums.

Turning to financial/monetary indicators, we display data for Europe's four largest economies – Germany, United Kingdom, France, and Italy. Inflation, as measured by the year-over-year increase in the Consumer Price Index, is currently lower in all four European countries than in the United States. In three countries, the yield curve from three months to ten years is much steeper (126 to 166 basis points) than in the U.S. (33 basis points). The fourth country, the UK, has a yield curve only nominally flatter than in the U.S. (22 basis points.) As with the default rate, the comparative readings for these indicators uphold the present, narrower-than-average OAS differential.

In the category of economic activity, however, the current statistics<sup>4</sup> favor the United States. Unemployment has fallen more sharply over the past year in the U.S. than in any of the four largest European economies. The advantage is not as clear-cut in industrial production. Germany has outperformed the U.S., but the U.S. has beaten the others. On the whole, the comparative levels of economic performance argue against the narrower-than-average differential currently observed between European and U.S. risk premiums.

### ***Conclusion***

Developing a full-blown model of the OAS differential between the European and U.S. high yield sectors is a project for another day. Less formal examination of the data, however, hints at some fundamental basis for the present small yield giveup, which represents an extreme in the historical series. Comparative default rates, inflation, and yield curves may have to change significantly before the OAS gap returns to something more like its historical average. The key point is that reliance on reversion to the mean is not the sole possible approach to comparing risk premiums across regions.

**LW**

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<sup>3</sup> All figures in Exhibit 2, other than default rates, are drawn from Bloomberg's World Economic Statistics (ECST <GO>). We replicated each U.S. statistic (ordinarily drawn from primary sources) with that function, then used analogous calculations to generate the other countries' statistics.

<sup>4</sup> *Leverage World's* Macro Tracker incorporates Capacity Utilization, in addition to the two indicators of economic activity discussed in this report. This statistic is not available on Bloomberg's ECST.

## Nalco: Followup

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By Martin Fridson, CFA  
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On March 17, 2006, Independent Inquiry highlighted the possibility of first-quarter weakness at Nalco Holding,<sup>1</sup> a provider of water-treatment and process-improvement services. This assessment was based on discussions with an engineering consultant who regularly deals with Nalco representatives and has several users of Nalco water treatment services among his clients. He related conversations that indicated slow sales at Nalco in January, internal concern about meeting sales targets, and the danger that smaller, more nimble competitors would steal market share.

Following the close on May 2, Nalco Holding announced first-quarter net income of \$8.8 million, or 6 cents a share, down from \$11 million, or 8 cents a share, in the comparable year-earlier period. According to Reuters Estimates, the analysts' consensus had been 13 cents a share. That put the magnitude of the earnings disappointment at 54% of expectations.

In response to the news, Nalco's stock fell by 6.6% on May 3 on 5.0 times the average daily volume of the preceding six months. By contrast, the Dow Jones Industrial Average finished the day nearly unchanged, declining by just 0.1%.<sup>2</sup> The bond market's response to the Nalco earnings disappointment was more muted, as the supply-hungry high yield market held steady during the week in the face of rising Treasury yields.

LW

*The stock market was caught by surprise by the earnings weakness hinted at almost two months ago in these pages*

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<sup>1</sup> "Leverage World," *Nalco: First-Quarter Indications* (March 17, 2006) pp. 11-13.

<sup>2</sup> Source: Bloomberg

## Recommendation

### *Sell Computer Associates International 6-1/2% due 4/15/08*

By Karen Sterling, Ph. D.  
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In this section of *Leverage World*, we highlight issues priced at yield spreads far tighter or far wider than purely statistical measures of credit quality can justify. To identify substantial disparities from fair value, we employ our Focus Issues Model.<sup>1</sup> We draw recommendations from the list of bonds trading at least one standard deviation<sup>2</sup> wider or tighter than the model's estimated spread. This week's analysis concentrates on Computer Associates International (NYSE: CA) 6-1/2% secured debentures due April 15, 2008.

As of May 4, 2006, the spread-to-worst (STW) on CA 6-1/2s stood at 59 basis points (**Exhibit 1**). Based on coupon, coverage ratio, and EBIT (the issue is not rated below B-), a spread of 175 would be expected. The difference between actual and estimated spread, 116 basis points, represents a disparity of 1.39 standard deviations.

**Exhibit 1: Focus Issues Model Estimates and Actual Spreads\***  
(Basis Points)

| Issue   | Ratings  | Price   | Effective Duration** | Effective Convexity† | Estimated Spread | Actual Spread | Potential Pickup |
|---|----------|---------|----------------------|----------------------|------------------|---------------|------------------|
| Computer Associates International<br>6-1/2% 4/15/08 | Ba1/BBB- | 101.000 | 1.788                | 0.042                | 175              | 59            | -116             |



\* As of May 4, 2006.

\*\* Effective duration measures price sensitivity to changes in yields, taking into account embedded options such as early redemption provisions.

† Effective convexity measures curvature of price sensitivity to a change in yields, taking into account embedded options such as early redemption provisions. A negative figure indicates that a bond's price increases less than duration predicts when rates fall, and decreases at least as much as duration predicts when rates rise.

Sources: Advantage Data, FridsonVision LLC.

**Exhibit 2** tracks the performance of the company's stock and 6-1/2s over the latest six-month stretch. CA stock underperformed the S&P 500 Index's 7.31% price return, delivering -11.53% since November 7, 2005. Over the same period, the bond's OAS widened by a negligible 2 basis points versus the Merrill Lynch High Yield Master II Index. The following factors suggest that risk premium expansion is likely on the 6-1/2s:

- **14% Year-over-Year Decline in Bookings.** Bookings in CA's third fiscal quarter (ended December 31, 2005) came in lower than expected on prominent international weakness, particularly in Europe, the Middle East and Africa. While North American bookings grew 11% year-over-year, international bookings dropped 36%, prompting management to initiate a restructuring of its international operations. Even if eventually successful, such initiatives take time and are potentially costly. In addition, a lower number of early renewals led to a decrease in new deferred subscription revenue.

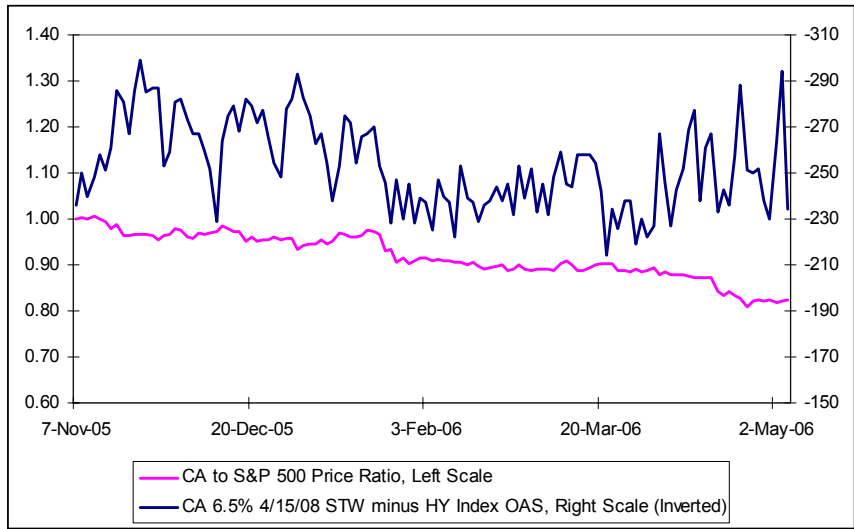
<sup>1</sup> For a detailed explanation of this model, see "Focus Issues Methodology" in the Sample Research section of [www.LeverageWorld.com](http://www.LeverageWorld.com).

<sup>2</sup> One standard deviation currently equals 77 basis points.

- **2% Organic Decline in Billings.** Third-quarter billings, which could be considered a better indicator of current business activity than bookings, declined by 2% on a trailing-twelve-month (TTM) basis. One of the main contributors to CA's negative billings growth was its troubled mainframe business, which declined by 5% on a TTM basis, due to pricing pressure and longer renewal cycles. While billings in security and professional services were up 21% and 34%, respectively, on a TTM basis, their modest contribution to total revenue was insufficient to fully offset CA's high level of exposure to the mainframe market. Slow or even negative growth and uncertainty surrounding this market sector makes a quick turnaround scenario appear unrealistic. .
- **Fourth-Quarter Financial Results to Come in Below Expectations.** On April 25, CA warned that its quarterly results would come in below expectations, precipitated by a revenue shortfall related to acquisitions, continued slow bookings, and higher expenses. Management expects total revenue for the quarter in the range of \$940 to \$950 million, versus previous guidance of \$975 million to \$1 billion. Increases in sales expenses (primarily commissions) and other expenses will serve to magnify the overall effect of the shortfall on operating earnings, which can be expected to fall in the range of \$0.00 to \$0.02 per share, versus previous guidance of \$0.09 to \$0.10 per share. At present, some of CA's numerous acquisitions are making solid contributions to earnings, whereas others are dilutive. While CA's acquisition strategy may prove successful in the long run, particularly with respect to alleviating the company's dependence on its core mainframe business, the process of integrating a host of small players into a cohesive organization is likely to be disruptive in the near term.
- **Valuation.** CA's issue is not only considered overvalued by our model, but also appears expensive on a ratings-based valuation. The 6-1/2s are rated Ba1/BBB- but are trading at a spread 73 basis points narrower than an average Ba1/BBB- issue. Furthermore, this is not a reflection of an industry effect, as the spread of 59 basis points on the issue is also 72 basis points narrower than the average spread on technology issues rated Ba1/BBB-.

**Exhibit 2: CA versus S&P 500 Price Ratio\* and CA 6-1/2s STW versus High Yield Index OAS\*\***

November 7, 2005 to May 4, 2006



\* November 7, 2005 = 1.0.

\*\* Merrill Lynch High Yield Master II Index.

Sources: Advantage Data, Merrill Lynch & Co., Yahoo! Finance.

**Company Description**

Founded in 1976 and headquartered in Islandia, New York, CA designs, markets, and supports information technology management software products. One of the largest infrastructure software management vendors worldwide, CA consists of five operating units: Enterprise Systems Management, Security Management, Storage Management, Business Service Optimization, and the CA Products Group. Professional services encompass consulting and education. Product distribution is achieved via CA's sales force, independent resellers, original equipment manufacturers, distributors and dealers, with clients including most of the Fortune 1000 companies, as well as various government entities and educational institutions. The company changed its name from Computer Associates International to CA in February 2006. For the fiscal year ended March 31, 2006, CA expects to record sales in the range of \$3.769 to \$3.779 billion and GAAP EPS in the range of \$0.31 to \$0.33. Currently, the company has three high yield issues with greater than \$1.3 billion outstanding. Computer Associates last accessed the high yield debt market in November 2004.

LW

## Focus Issues

| Spread Wider than Estimated<br>by Financial Statement Data |         |            | Spread May 1, 2006 |        |            |
|--|---------|------------|--------------------|--------|------------|
| Issuer   | Coupon  | Maturity   | Estimated          | Actual | Difference |
| Alliance Imaging   | 7.250%  | 12/15/2012 | 246                | 484    | 238        |
| Chiquita Brands International                              | 7.500%  | 11/1/2014  | 269                | 511    | 242        |
| Chiquita Brands International                              | 8.875%  | 12/1/2015  | 169                | 348    | 179        |
| Columbia/HCA*  | 7.500%  | 11/15/2095 | 169                | 348    | 179        |
| Friendly Ice Cream   | 8.375%  | 6/15/2012  | 316                | 590    | 274        |
| Hertz*   | 6.250%  | 3/15/2009  | 118                | 287    | 169        |
| Hertz  | 7.400%  | 3/1/2011   | 118                | 287    | 169        |
| Hertz  | 7.625%  | 6/1/2012   | 149                | 328    | 179        |
| Hines Horticulture   | 10.250% | 10/1/2011  | 155                | 344    | 189        |
| PRIMEDIA   | 8.000%  | 5/15/2013  | 265                | 498    | 233        |
| PRIMEDIA   | 8.875%  | 5/15/2011  | 289                | 492    | 203        |
| Quebecor   | 6.500%  | 8/1/2027   | 248                | 428    | 180        |
| Rent-Way   | 11.875% | 6/15/2010  | 378                | 572    | 194        |
| Rotech Healthcare  | 9.500%  | 4/1/2012   | 320                | 862    | 542        |
| Sea Containers   | 7.875%  | 2/15/2008  | 386                | 940    | 554        |
| Sea Containers   | 10.500% | 5/15/2012  | 582                | 1,208  | 626        |
| Stoneridge   | 11.500% | 5/1/2012   | 384                | 810    | 426        |
| WCI Communities  | 6.625%  | 3/15/2015  | 185                | 379    | 194        |

| Spread Narrower than Estimated<br>by Financial Statement Data |         |            | Spread May 1, 2006 |        |            |
|---|---------|------------|--------------------|--------|------------|
| Issuer  | Coupon  | Maturity   | Estimated          | Actual | Difference |
| Ashland Oil   | 8.800%  | 11/15/2012 | 213                | 30     | -183       |
| Avista  | 9.750%  | 6/1/2008   | 299                | 115    | -184       |
| Avnet   | 9.750%  | 2/15/2008  | 280                | 96     | -184       |
| CSK Auto  | 7.000%  | 1/15/2014  | 506                | 273    | -233       |
| Hanger Orthopedic   | 10.375% | 2/15/2009  | 606                | 318    | -288       |
| Mothers Work*   | 11.250% | 8/1/2010   | 659                | 436    | -223       |

\* Addition since last update.

**Model Update**

The current version of the multiple regression formula is presented here:

$$\text{Spread} = 145.99 + 268.17a + 27.21b - 1.54c - 49.09d$$

Where:

145.99 is a constant

a = Dummy variable for CCC+ or lower rating (Yes = 1, No = 0)

b = Coupon, expressed without considering percentage sign, i.e., 7.5% = 7.5, not 0.075

c = Coverage, defined as EBITDA divided by interest expense

d = Earnings, defined as log of trailing-twelve-months EBIT in millions of dollars

Regression Statistics:

Standard Error = 83.45 basis points

R<sup>2</sup> = 50.6%

Adjusted R<sup>2</sup> = 50.3%

| Predictor | t-statistic | P-Value |
|-----------|-------------|---------|
| Constant  | 5.08        | 0.000   |
| a         | 14.45       | 0.000   |
| b         | 9.21        | 0.000   |
| c         | -1.84       | 0.066   |
| d         | -8.94       | 0.000   |

The analysis indicates that each explanatory variable is significant at the 93.0% confidence level or greater. In no case is there greater than a 7.0% probability that variable's coefficient is equal to 0, which would signify that the variable has no explanatory power.

**Focus Issues: Why Are They on the List?**

The key to exploiting the Focus Issues list is fundamental analysis of factors outside the historical financial statements. If, in the investor's judgment, the factors do not fully justify the disparity between the bond's estimated and actual yields, the investor should regard the bond as an opportunity to enhance relative performance. The following comments provide the basic reason for each of this week's additions to and departures from the list.

**ISSUERS WITH ISSUES THAT ENTERED THE:**

***Yielding-More-than-Estimated List***

**Columbia/HCA's** 7-1/2s entered the yielding-more-than-estimated list following the company's announcement of an 8.5% drop in first-quarter earnings, brought about by lower hospital admissions and rising labor and supply costs. In addition, the High Yield Health Care group underperformed the overall index by 0.255%.

**Hertz's** 6-1/4s widened for no apparent reason, despite the Consumer Cyclical Services group performing in line with the overall index.

*Yielding-Less-than-Estimated List*

**Mothers Work's** 11-1/4s entered the yielding-less-than-estimated list after the company reported better-than-expected results for the quarter ended March 31, 2006 and raised its guidance for fiscal year 2006. In addition, the High Yield Retailers group outperformed the overall index.

## ISSUERS WITH ISSUES THAT EXITED THE:

*Yielding-More-than-Estimated List*

| Issuer               | Coupon  | Maturity  | Spread on 4/24 | Spread on 5/1 | Change |
|----------------------|---------|-----------|----------------|---------------|--------|
| Abitibi-Consolidated | 7.400%  | 4/1/2018  | 433            | 370           | -63    |
| Abitibi-Consolidated | 7.500%  | 4/1/2028  | 414            | 389           | -25    |
| Abitibi-Consolidated | 8.500%  | 8/1/2029  | 489            | 434           | -55    |
| Abitibi-Consolidated | 8.850%  | 8/1/2030  | 487            | 437           | -50    |
| Boise Cascade        | 9.450%  | 11/1/2009 | 482            | 425           | -57    |
| Milacron             | 11.500% | 5/15/2011 | 908            | 803           | -105   |
| WCI Communities      | 7.875%  | 10/1/2013 | 391            | 376           | -15    |

**Abitibi's** 7.4s, 7-1/2s, 8-1/2s and 8.85s all saw their spreads tighten after the company reported improved financial results in the form of a narrowed first-quarter loss. Management announced plans to cut another 200 jobs as part of an initiative to reduce SG&A costs by an additional \$35 million and further streamline operations. The four issues gained 3-3/4, 1-1/2, 4, and 3-5/8 points, respectively. In addition, the High Yield Paper group strongly outperformed the overall index.

**Boise Cascade's** 9.45s gained 1-1/2 points and tightened after the company's first-quarter results beat analyst estimates. Having closed 109 unprofitable stores, OfficeMax continues to trim labor and advertising costs to speed up its turnaround. In addition, the High Yield Paper group strongly outperformed the overall index.

**Milacron's** 11-1/2s gained 3-5/8 points and tightened on news of higher first-quarter sales and an 11% increase in orders.

**WCI Communities's** 7-7/8s gained 1/8 of a point for no apparent reason as the High Yield Home Construction group underperformed the overall index.

*Yielding-Less-than-Estimated List*

| Issuer           | Coupon | Maturity  | Spread on 4/24 | Spread on 5/1 | Change |
|------------------|--------|-----------|----------------|---------------|--------|
| Alderwoods Group | 7.750% | 9/15/2012 | 95             | 84            | -11    |
| JLG Industries   | 8.250% | 5/1/2008  | 69             | 89            | 20     |

**Alderwoods's** 7-3/4s were removed from our sample due to screening criteria.

**JLG Industries's** 7-5/8s widened and exited the yielding-less-than-estimated list in conjunction with the High Yield Construction Machinery group underperforming the overall index.

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**SECURITY SELECTION...**

## Senior versus Subordinated Spreads

**Exhibit 1: Pairs with Largest Difference between Subordinated and Senior Spreads**

Data as of May 3, 2006

| Issuer            | Coupon (%) | Maturity   | Sub. ? | S&P Rating | Moody's Rating | Price  | YTW (%) | OAS <sup>1,2</sup> | Pickup <sup>1</sup> |
|-------------------|------------|------------|--------|------------|----------------|--------|---------|--------------------|---------------------|
| METALDYNE         | 10.000     | 11/1/2013  | N      | CCC+       | Caa1           | 97.00  | 10.59   | 516                |                     |
| METALDYNE         | 11.000     | 6/15/2012  | Y      | CCC+       | Caa2           | 88.00  | 13.98   | 852                | 336                 |
| COOPER STANDARD   | 7.000      | 12/15/2012 | N      | B-         | B3             | 93.50  | 8.29    | 306                |                     |
| COOPER STANDARD   | 8.375      | 12/15/2014 | Y      | B-         | Caa1           | 83.25  | 11.49   | 608                | 302                 |
| HAWAIIAN TELCOM   | 9.750      | 5/1/2013   | N      | CCC+       | B3             | 105.25 | 8.44    | 314                |                     |
| HAWAIIAN TELCOM   | 12.500     | 5/1/2015   | Y      | CCC+       | Caa1           | 107.50 | 10.94   | 543                | 229                 |
| AMKOR TECHNOLOGY* | 9.250      | 2/15/2008  | N      | CCC+       | Caa1           | 105.50 | 5.94    | 93                 |                     |
| AMKOR TECHNOLOGY* | 10.500     | 5/1/2009   | Y      | CCC        | Caa3           | 101.88 | 8.49    | 318                | 226                 |
| STANDARD PACIFIC  | 6.500      | 10/1/2008  | N      | BB         | Ba2            | 99.50  | 6.73    | 168                |                     |
| STANDARD PACIFIC  | 9.250      | 4/15/2012  | Y      | B+         | Ba3            | 102.25 | 8.76    | 361                | 193                 |

\* Addition since last update.

<sup>1</sup> In basis points.

<sup>2</sup> Option-adjusted spread.

Sources: Bloomberg, Lehman Brothers.

**Exhibit 2: Pairs with Smallest Difference between Subordinated and Senior Spreads**

Data as of May 3, 2006

| Issuer             | Coupon (%) | Maturity   | Sub. ? | S&P Rating | Moody's Rating | Price  | YTW (%) | OAS <sup>1,2</sup> | Pickup <sup>1</sup> |
|--------------------|------------|------------|--------|------------|----------------|--------|---------|--------------------|---------------------|
| MGM MIRAGE         | 7.000      | 11/15/2036 | N      | BB         | Ba2            | 102.25 | 6.82    | 216                |                     |
| MGM MIRAGE         | 9.750      | 6/1/2007   | Y      | B+         | Ba3            | 103.75 | 6.08    | 107                | -109                |
| KB HOME            | 7.250      | 6/15/2018  | N      | BB+        | Ba1            | 97.98  | 7.50    | 214                |                     |
| KB HOME            | 8.625      | 12/15/2008 | Y      | BB-        | Ba2            | 105.32 | 6.38    | 134                | -80                 |
| LEUCADIA NATIONAL* | 7.000      | 8/15/2013  | N      | BB         | Ba2            | 99.25  | 7.13    | 199                |                     |
| LEUCADIA NATIONAL* | 8.650      | 1/15/2027  | Y      | B          | Ba3            | 104.25 | 8.00    | 144                | -55                 |
| HERTZ              | 7.625      | 6/1/2012   | N      | B          | B2             | 95.00  | 8.70    | 355                |                     |
| HERTZ              | 10.500     | 1/1/2016   | Y      | B          | B3             | 110.75 | 8.55    | 303                | -52                 |
| SMITHFIELD FOODS   | 7.750      | 5/15/2013  | N      | BB         | Ba2            | 101.00 | 7.56    | 242                |                     |
| SMITHFIELD FOODS   | 7.625      | 2/15/2008  | Y      | BB-        | Ba3            | 101.00 | 7.01    | 196                | -46                 |

\* Addition since last update.

<sup>1</sup> In basis points.

<sup>2</sup> Option-adjusted spread.

Sources: Bloomberg, Lehman Brothers.

***Update***

Amkor Technology's subordinated 10-1/2s of 2009 are potentially attractive relative to the company's senior 9-1/4s of 2008, based on the two issues' option-adjusted spreads. A similar relationship existed last week between Graphic Packaging's subordinated 9-1/2s of 2013 and senior 8-1/2s of 2011. Since then, the subs gained 1-3/4 points (40 basis points of OAS) on the seniors.

***Methodology***

For investors hoping to capitalize on short-run pricing discrepancies within a single company's capital structure, a key challenge is monitoring the universe for trading opportunities. Our "Senior versus Subordinated Spreads" feature serves this need. The objective is to identify each week the five largest and five smallest option-adjusted spread differences among senior-and-subordinated pairs of bonds.

We do not advise investors to take long-and-short positions based purely on this information, but rather to use the lists to concentrate their analysis on the most promising trade possibilities. Analysts should bear in mind that in principle, the risk premium for subordination should increase as the probability of default increases. It is in defaults that the disadvantage of subordination becomes real, through a smaller percentage recovery of principal, vis-à-vis senior creditors.

At present, the universe considered in the analysis consists of 144 bonds. They include all nondistressed issues within the Lehman Brothers U.S. Corporate High Yield Index that are obligations of companies represented in the index by at least one senior and at least one subordinated bond. The pricing source is the Lehman index.

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## Debt versus Equity

**Exhibit 1: Equity Outperforming Debt (U.S.)**

April 26, 2006 to May 3, 2006

| Identifier | Issuer               | Coupon (%) | Maturity | Stock Ticker | Bond Price Change | Stock Price Change | Difference |
|------------|----------------------|------------|----------|--------------|-------------------|--------------------|------------|
| 743659AR   | PROTECTION ONE ALARM | 8.125      | 01/15/09 | PONN US      | 0.00%             | 25.71%             | -25.71%    |
| 29444NAH   | EQUISTAR CHEMICALS   | 10.625     | 05/01/11 | LYO US       | 0.23%             | 16.13%             | -15.90%    |
| 75040KAC   | RADIOLOGIX           | 10.500     | 12/15/08 | RGX US       | 0.31%             | 16.18%             | -15.88%    |
| 87264QAM   | TRW AUTOMOTIVE       | 9.375      | 02/15/13 | TRW US       | 0.00%             | 15.32%             | -15.32%    |
| 369300AC   | GENERAL CABLE        | 9.500      | 11/15/10 | BGC US       | -0.35%            | 14.66%             | -15.01%    |
| 46126PAB   | INVERNESS MEDICAL    | 8.750      | 02/15/12 | IMA US       | 0.00%             | 14.01%             | -14.01%    |
| 882848AH   | TEXAS UTILITIES      | 6.375      | 01/01/08 | TXU US       | 0.05%             | 13.62%             | -13.57%    |
| 36318MAA   | GALAXY ENTERTAINMENT | 9.875      | 12/15/12 | 27 HK        | 0.12%             | 13.39%             | -13.27%    |
| 031652AQ   | AMKOR TECHNOLOGIES   | 7.750      | 05/15/13 | AMKR US      | 0.00%             | 13.03%             | -13.03%    |
| 92839UAC   | VISTEON              | 7.000      | 03/10/14 | VC US        | 7.23%             | 20.00%             | -12.77%    |

Sources: Bloomberg, Lehman Brothers.

**Exhibit 2: Debt Outperforming Equity (U.S.)**

April 26, 2006 to May 3, 2006

| Identifier | Issuer                 | Coupon (%) | Maturity | Stock Ticker | Bond Price Change | Stock Price Change | Difference |
|------------|------------------------|------------|----------|--------------|-------------------|--------------------|------------|
| 26632QAK   | DURA OPERATING         | 8.625      | 04/15/12 | DRRA US      | -1.16%            | -21.14%            | 19.98%     |
| 98375YAQ   | XM SATELLITE RADIO     | 9.750      | 05/01/14 | XMSR US      | -1.24%            | -20.45%            | 19.20%     |
| 313139AG   | FEDDERS NORTH AMERICA  | 9.875      | 03/01/14 | FJC US       | 0.63%             | -14.92%            | 15.54%     |
| 87971KAA   | TEMBEC INDUSTRIES      | 8.625      | 06/30/09 | TBC CN       | 1.28%             | -13.81%            | 15.09%     |
| 896778AH   | TRITON PCS             | 8.750      | 11/15/11 | TPC US       | -1.33%            | -16.00%            | 14.67%     |
| 880349AH   | TENNECO AUTOMOTIVE     | 8.625      | 11/15/14 | TEN US       | 0.50%             | -12.28%            | 12.77%     |
| 42222GAC   | HEALTH NET             | 9.875      | 04/15/11 | HNT US       | 0.01%             | -12.32%            | 12.33%     |
| 624581AB   | MOVIE GALLERY          | 11.000     | 05/01/12 | MOVI US      | 4.76%             | -7.45%             | 12.21%     |
| 442488AM   | HOVNIANIAN ENTERPRISES | 8.875      | 04/01/12 | HOV US       | 0.60%             | -11.52%            | 12.12%     |
| 003924AC   | ABITIBI                | 7.500      | 04/01/28 | A CN         | 1.81%             | -9.90%             | 11.70%     |

Sources: Bloomberg, Lehman Brothers.

**Update**

General Cable's 9-1/2s of 2010 are potentially attractive after declining by 0.35% despite a 14.66% rise in the related stock. Last week, Lear's 5-3/4s of 2014 were in a similar position after underperforming the related stock by 16.67 percentage points. Since then, the bond outperformed the stock by 4.44 percentage points.

**SECURITY SELECTION...**

**Exhibit 3: Equity Outperforming Debt (European)**

April 26, 2006 to May 3, 2006

| Identifier   | Issuer                     | Coupon (%) | Maturity | Stock Ticker | Bond Price Change | Stock Price Change | Difference |
|--------------|----------------------------|------------|----------|--------------|-------------------|--------------------|------------|
| XS0181090001 | TRW AUTOMOTIVE             | 10.125     | 02/15/13 | TRW US       | 0.00%             | 15.32%             | -15.32%    |
| XS0250487922 | KRONOS INTERNATIONAL       | 6.500      | 04/15/13 | NL US        | -0.11%            | 14.55%             | -14.67%    |
| US001084AK86 | AGCO                       | 6.875      | 04/15/14 | AG US        | 0.49%             | 13.54%             | -13.06%    |
| XS0184717956 | HTM SPORT-UND FREIZEIT     | 8.500      | 02/01/14 | HEAD AV      | 0.00%             | 6.34%              | -6.34%     |
| XS0213135998 | WARNER MUSIC               | 8.125      | 04/15/14 | WMG US       | 0.00%             | 6.06%              | -6.06%     |
| XS0226613452 | GLOBAL CROSSING UK FINANCE | 11.750     | 12/15/14 | GLBC US      | 2.80%             | 8.59%              | -5.78%     |
| US52729NAW02 | LEVEL 3 COMMUNICATIONS     | 11.250     | 03/15/10 | LVLT US      | 2.81%             | 8.19%              | -5.38%     |
| XS0147412083 | EL PASO                    | 7.125      | 05/06/09 | EP US        | 0.00%             | 5.32%              | -5.32%     |
| XS0218256468 | OWENS-BROCKWAY             | 6.750      | 12/01/14 | OI US        | -2.94%            | 2.03%              | -4.97%     |
| XS0195957658 | DUERR                      | 9.750      | 07/15/11 | DUE GR       | 0.00%             | 3.96%              | -3.96%     |

Sources: Bloomberg, Lehman Brothers.

**Exhibit 4: Debt Outperforming Equity (European)**

April 26, 2006 to May 3, 2006

| Identifier   | Issuer            | Coupon (%) | Maturity | Stock Ticker | Bond Price Change | Stock Price Change | Difference |
|--------------|-------------------|------------|----------|--------------|-------------------|--------------------|------------|
| XS0101338829 | DURA OPERATING    | 9.000      | 05/01/09 | DRRA US      | 0.89%             | -21.14%            | 22.03%     |
| XS0195787634 | RHODIA            | 10.500     | 06/01/10 | RHA FP       | 0.00%             | -10.65%            | 10.65%     |
| FR0000492092 | ALCATEL ALSTHOM   | 4.375      | 02/17/09 | CGE FP       | 0.02%             | -10.02%            | 10.03%     |
| XS0183955417 | IRON MOUNTAIN     | 7.250      | 04/15/14 | IRM US       | 0.00%             | -7.67%             | 7.67%      |
| XS0148585127 | FORD MOTOR CREDIT | 7.250      | 12/07/07 | F US         | 0.30%             | -6.48%             | 6.78%      |
| XS0207844829 | CHESAPEAKE        | 7.000      | 12/15/14 | CSK US       | 4.56%             | -1.13%             | 5.69%      |
| XS0171942757 | GENERAL MOTORS    | 7.250      | 07/03/13 | GM US        | 2.51%             | -2.85%             | 5.36%      |
| XS0147559263 | EMI               | 9.750      | 05/20/08 | EMI LN       | 0.00%             | -5.34%             | 5.34%      |
| GB0001290138 | BRITISH AIRWAYS   | 10.875     | 06/15/08 | BAY LN       | 0.00%             | -4.58%             | 4.58%      |
| XS0196635402 | GILDEMEISTER      | 9.750      | 07/19/11 | GIL GR       | 0.23%             | -4.32%             | 4.54%      |

Sources: Bloomberg, Lehman Brothers.

**Update**

Kronos International's 6-1/2s of 2013 are potentially attractive after declining by 0.11% despite a 14.55% rise in the related stock. Last week, EMI's 8-5/8s of 2013 were in a similar position after underperforming the related stock by 12.05%. Since then, the bond outperformed the stock by 5.13 percentage points.

### *Methodology*

Underlying the analysis presented in “Debt versus Equity” is the basic premise of intercapital trading. The notion is that all securities within a company’s capital structure derive their value from the same set of expected future cash flows. It follows that if the company’s expected cash flows increase (decrease), the value of both its bonds and its stock rise (fall). Suppose, then, that a company’s bond and stock are correctly valued, relative to each other, on a given date. If the bond price then falls while the stock price rises, then bond must become undervalued, relative to the stock. Conversely, a rise in the bond’s price, coincident with a drop in the stock price, renders the bond overvalued, relative to the stock. Misalignment can also result if the stock and bond move in the same direction, but they do not both move in proper proportion to the change in expected future cash flows.

Like our “Focus Issues” and “Senior versus Subordinated Spreads” analyses, “Debt versus Equity” is meant to be a preliminary screen. Investors should not reflexively buy all bonds that appear to lag their associated stocks or sell all bonds that appear to leap ahead of their associated stocks. Rather, they should use the list as a means of concentrating scarce research resources on issues with a strong likelihood of offering profits through capitalizing on relative misvaluation. In some cases, the seeming disparity may reflect a circumstance such as the following:

- The stock and bond were previously misaligned. The recent, nonproportional price movements have returned the securities to their proper relative relationship.
- The stock and bonds were previously *very* misaligned. Even after the recent movement, the securities remain out of line with each other, with the error in the same direction as before.
- The larger absolute movement in the stock, in the same direction as the movement in the bond, merely represents an appropriately larger move in the security at the bottom of the capital structure.
- The short-run divergence between the stock and bond movements is justified by a fundamental development. For example, an announcement that a company will sharply increase its financial leverage often causes its stock to rise, while its bonds decline as a function of heightened default risk.

### *Using the Tables*

Our analysis covers both the U.S. (**Exhibits 1 and 2**) and European (**Exhibits 3 and 4**) high yield markets. The former includes all bonds in the Lehman Brothers U.S. Corporate High Yield Index and their corresponding stocks, while the latter looks at the Lehman Brothers Pan-European High Yield Index and the corresponding stocks. Some equity issuers are represented by more than one bond issue apiece.

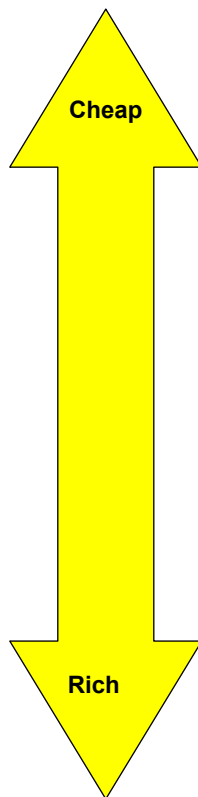
Exhibits 1 and 3 list the bonds that are most likely to be attractive as BUYs. They are the ten issues that most dramatically underperformed their corresponding stocks, in terms of simple price change, in the latest week. Exhibit 2 and 4 list the bonds that are most likely to be attractive as SELLs. They are the ten issues that most dramatically outperformed their corresponding stocks. Naturally, the data in Exhibits 1 and 2 or 3 and 4 can also be used for market-neutral trading, with a long (short) position in the bond offset by a short (long) position in the corresponding stock.

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## Industry Value Tracker

The Industry Value Tracker ranks industries within the Lehman Brothers U.S. Corporate High Yield Index according to the percentage of issues trading wider (by even one basis point) than the spreads estimated for them by the Focus Issues Model. (For an explanation of this model, see “Focus Issues Methodology” and “Performance of Focus Issues” in the Sample Research section of [www.LeverageWorld.com](http://www.LeverageWorld.com).) The underlying premise is that if an industry has a pronounced concentration of undervalued (overvalued) issues, it probably reflects a group effect whereby investors are shunning (flocking to) an industry more energetically than the fundamentals warrant.

Portfolio managers should not attempt to fine-tune their portfolios to minor differences in rankings. Instead, we recommend that they concentrate on overweighting or underweighting major industries (those with large numbers of outstanding issues) that appear near the top or bottom of the table.



**Exhibit 1: Industry Value Tracker\***

| Industry                   | % Trading Wider than Estimated | Total # of Issues |
|----------------------------|--------------------------------|-------------------|
| Paper                      | 83.33%                         | 12                |
| Automotive                 | 82.35%                         | 17                |
| Media Non-Cable            | 81.48%                         | 27                |
| Packaging                  | 73.33%                         | 15                |
| Independent Energy         | 71.11%                         | 45                |
| Wirelines                  | 62.96%                         | 27                |
| Health Care                | 58.82%                         | 51                |
| Metals/Mining              | 58.33%                         | 12                |
| Consumer Cyclical Services | 56.00%                         | 25                |
| Retailers                  | 52.63%                         | 38                |
| Chemicals                  | 50.00%                         | 18                |
| Environmental              | 46.67%                         | 15                |
| Food & Beverage            | 46.67%                         | 15                |
| Consumer Products          | 46.15%                         | 13                |
| Transportation Services    | 42.86%                         | 14                |
| Media Cable                | 38.46%                         | 13                |
| Technology                 | 38.46%                         | 39                |
| Industrial Other           | 35.71%                         | 14                |
| Aerospace/Defense          | 29.41%                         | 17                |
| Pipelines                  | 23.53%                         | 51                |
| Gaming                     | 23.53%                         | 17                |
| Electric                   | 16.95%                         | 59                |
| Oil Field Services         | 15.79%                         | 19                |
| Wireless                   | 14.29%                         | 14                |
| Lodging                    | 7.14%                          | 14                |

\* Based on Spreads as of May 1, 2006.

Sources: Advantage Data, FridsonVision LLC, Lehman Brothers.

### Update

Pipelines entered the rich and therefore too well-liked zone, defined as having fewer than 25% of its issues quoted wider than their model-estimated spreads, despite having underperformed the overall index by 0.531% over the past week. On the opposite side, the cheap zone remained unchanged from the previous week.

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## Credit Ratings Value Tracker

Our evaluation is not based on historical yield spreads, but instead on each rating category's degree of concentration in issues trading wider than the spreads estimated by our Focus Issues Model.<sup>1</sup> The higher the percentage shown in the middle column, the better is the indicated relative value. (See accompanying conversion table to determine a bond's senior-equivalent rating, based on its nominal rating.)

### Exhibit 1: Credit Ratings Value Tracker\*

| Senior-Equivalent Rating | % Trading Wider than Estimated | Total # of Issues |
|--------------------------|--------------------------------|-------------------|
| BBB                      | 32.76%                         | 58                |
| BB                       | 41.41%                         | 355               |
| B                        | 52.38%                         | 231               |
| CCC                      | 76.92%                         | 13                |

\* Based on Spreads as of May 1, 2006.

Sources: Advantage Data, FridsonVision LLC.

### Exhibit 2: Conversion Table

| Senior-Equivalent Rating | S&P Rating | Seniority    |
|--------------------------|------------|--------------|
| BBB                      | BBB        | Senior       |
|                          | BBB-       | Senior       |
|                          | BB+        | Subordinated |
|                          | BB         | Subordinated |
| BB                       | BB+        | Senior       |
|                          | BB         | Senior       |
|                          | BB-        | Senior       |
|                          | BB-        | Subordinated |
|                          | B+         | Subordinated |
| B                        | B          | Subordinated |
|                          | B-         | Senior       |
|                          | B-         | Senior       |
|                          | B-         | Subordinated |
|                          | CCC+       | Subordinated |
|                          | CCC        | Subordinated |
| CCC                      | CCC+       | Senior       |
|                          | CCC        | Senior       |
|                          | CCC-       | Senior       |
|                          | NR         | Senior       |
|                          | CCC-       | Subordinated |
|                          | CC         | Subordinated |
|                          | NR         | Subordinated |

Source: FridsonVision LLC.

### Update

Portfolio managers should no longer actively swap out of bonds of Double-B companies (including subordinated issues rated B+ or B) into bonds of Single-B companies (including subordinated issues rated CCC+ or CCC), since the differential in percentage of issues quoted wider than their model-estimated spreads, 52.38% - 41.41% = 10.97 percentage points, is no longer at an extreme. (Our cutoff value for defining an extreme disparity in valuation is 15 percentage points.) Bonds of companies rated Triple-B at the senior level currently offer the least value of all, with a percentage-wider-than-estimated ratio of 32.76%.

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<sup>1</sup> See "Focus Issues Methodology" in the Sample Research section of [www.LeverageWorld.com](http://www.LeverageWorld.com).

# Macro Tracker

## Update

The spread-versus-Treasuries tightened by a further seven basis points to 314 basis points between April 26 and May 3. The U.S. High Yield Master II Index posted a strong total return of 0.36% (20.27% annualized) over the same period. High yield outperformed other fixed income markets as Treasury notes, corporates, and mortgages all posted negative or smaller positive returns. Within the speculative grade sector, bonds of retailers and building materials companies performed strongly, while integrated energy and wireless issues significantly underperformed the overall index. The yield curve remained unchanged over the past week. Overall, the absolute ratings of Macro Tracker variables (“Impact of Current”) are favoring tighter spreads by a ratio of 2-to-1. Next week’s update will include April observations for Default Rate and Change in Unemployment Rate, the two Macro Tracker variables with the highest correlation with the high yield risk premium.

## Methodology

The Macro Tracker analyzes the high yield cycle by focusing on factors that have a demonstrable relationship with the risk premium (spread-versus-Treasuries). Running commentary on these key determinants of the high yield risk premium will complement our reporting of capital flows into and out of the speculative grade sector. **Exhibit 1** lists six factors included in the Macro Tracker. **Exhibit 2** enables investors to gain perspective on the current value of the spread and each of its determinants by providing descriptive statistics for the historical series.

Current readings appear in **Exhibit 3**. To facilitate comparability among the six determinants of the spread, we display the magnitude of each variable’s divergence from its average in terms of a common unit, namely, standard deviation. In general, a small standard-deviation divergence should have only a small impact on the spread. Rather than burden readers with the mental chore of figuring out, in each instance, whether, all else being equal, a positive divergence is consistent with a lower-than-average spread, or vice versa, we supply the answer in the “Impact of Current” column. “Impact of Change” indicates whether the rise or fall from the previous reading implies a narrower spread (“Favorable”) or a wider spread (“Unfavorable”), all else being equal.

**Exhibit 1: Descriptive Information**

| Name                                       | Mnemonic | Description                  | Freq.* | Source                     |
|--|----------|------------------------------|--------|----------------------------|
| <b>HIGH YIELD SPREAD-VERSUS-TREASURIES</b> | SPREAD   | Master II versus 10-Yr Index | W      | Merrill Lynch & Co.        |
| <b>Default Rate</b>                        | DRATE    | U.S. % of Issuers (TTM)      | M      | Moody's Investors Service  |
| <b>Change in Unemployment Rate</b>         | ΔUNEMP   | Year-over-Year               | M      | Bureau of Labor Statistics |
| <b>Change in Industrial Production</b>     | ΔINDPRO  | Year-over-Year               | M      | Federal Reserve            |
| <b>Capacity Utilization</b>                | CAPUT    | Percent of Capacity          | M      | Federal Reserve            |
| <b>Change in Consumer Price Index</b>      | ΔCPI     | Year-over-Year               | M      | Bureau of Labor Statistics |
| <b>Yield Curve</b>                         | YCURVE   | 10-Yr versus 3-Mo Treasuries | W      | Federal Reserve            |

\* Frequency with W=Weekly and M=Monthly.  
Source: FridsonVision LLC.

**MARKET TIMING...**

**Exhibit 2: Descriptive Statistics**  
September 1986 to April 2006\*, Monthly

| Variable       | Average | Median | St. Dev. | High   | Low     | Correlation with SPREAD |
|----------------|---------|--------|----------|--------|---------|-------------------------|
| <b>SPREAD</b>  | 510     | 464    | 176      | 1,009  | 286     | -                       |
| <b>DRATE</b>   | 5.18%   | 4.51%  | 2.84%    | 13.00% | 1.39%   | 79.03%                  |
| <b>ΔUNEMP</b>  | -1.09%  | -5.26% | 12.58%   | 46.15% | -18.18% | 68.64%                  |
| <b>ΔINDPRO</b> | 3.00%   | 3.42%  | 2.94%    | 8.54%  | -5.53%  | -69.31%                 |
| <b>CAPUT</b>   | 80.99%  | 81.70% | 2.86%    | 85.10% | 73.90%  | -52.01%                 |
| <b>ΔCPI</b>    | 3.07%   | 2.96%  | 1.10%    | 6.38%  | 1.07%   | 23.14%                  |
| <b>YCURVE</b>  | 1.70%   | 1.59%  | 1.15%    | 3.68%  | -0.70%  | -6.20%                  |

\* In case April 2006 data is not yet available for a series, then through March 2006.  
Sources: Bureau of Labor Statistics, Federal Reserve, Merrill Lynch & Co., and Moody's Investors Service.

**Exhibit 3: Macro Tracker**  
As of May 3, 2006

| Variable       | Current | As of    | St. Dev.* | Impact of Current | Previous Reading | Impact of Change |
|----------------|---------|----------|-----------|-------------------|------------------|------------------|
| <b>SPREAD</b>  | 314     | 5/3/2006 | -1.11     | -                 | 321              | -                |
| <b>DRATE</b>   | 2.26%   | Mar-06   | -1.03     | Favorable         | 2.17%            | Unfavorable      |
| <b>ΔUNEMP</b>  | -7.84%  | Mar-06   | -0.54     | Favorable         | -11.11%          | Unfavorable      |
| <b>ΔINDPRO</b> | 3.63%   | Mar-06   | 0.21      | Favorable         | 2.99%            | Favorable        |
| <b>CAPUT</b>   | 81.30%  | Mar-06   | 0.11      | Favorable         | 81.00%           | Favorable        |
| <b>ΔCPI</b>    | 3.42%   | Mar-06   | 0.32      | Unfavorable       | 3.64%            | Favorable        |
| <b>YCURVE</b>  | 0.33%   | 5/3/2006 | -1.18     | Unfavorable       | 0.33%            | Neutral          |

\* Current value minus historical mean, expressed in standard deviations.  
Sources: Bureau of Labor Statistics, Federal Reserve, Merrill Lynch & Co., and Moody's Investors Service.

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## Department of Corrections

### *Tall Tales*

This week's passing of economist John Kenneth Galbraith (1908-2006) provided colorful copy for obituary writers. Galbraith, who stood six feet, eight inches,<sup>1</sup> was a giant in wit, if not necessarily in the esteem of economists with a more quantitative orientation. He coined such phrases as "conventional wisdom" and "the bland leading the bland." The journalistic summaries of his life and career included the following witticisms:

- "Economists are economical, among other things, of ideas; most make those of their graduate days last a lifetime."
- "Wealth is not without its advantages, and the case to the contrary, although it has often been made, has never proved widely persuasive."
- *On the U.S. stock market's 1990s surge:*  
"There is too much money chasing too little intelligence to manage it. It can't last."
- *On his widely admired prose:*  
"It was usually on about the fourth day that I put in that note of spontaneity for which I am known."
- *On supply side economics:*  
"If you feed the horse enough oats, the sparrow will survive on the highway."

***Galbraith derided trickle-down economics with a metaphor that reflected his agrarian upbringing***

Inevitably, the Fourth Estate's memorializing of Galbraith also generated some factual errors. For example, the *Associated Press* included a tribute from the heretofore unheralded "Benjamin Freeman, a Harvard economics professor and friend of Galbraith's." Presumably, the name that the wire service was groping for was Benjamin Friedman, the William Joseph Maier Professor of Political Economy and former chairman of Harvard's economics department.

According to the *Financial Times*, "It was after running [John F.] Kennedy's successful 1960 campaign that Galbraith spent a controversial time in India as U.S. ambassador." In reality, the campaign manager for Kennedy's presidential run was his brother, and later his Attorney General, Robert. Galbraith did, however, serve as a floor manager for JFK at the Democratic nominating convention.

The Department of Corrections is honored to provide its unsolicited assistance to these eminent news outlets, which undoubtedly share our dedication to getting the facts straight.

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<sup>1</sup> Or, in the opinion of *Yahoo! News*, six feet, seven inches.

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