

Value vs. Glamour: Bond Performance

Since our inception in 2002, the Brandes Institute, a division of Brandes Investment Partners, L.P., has published a number of pieces illustrating the long-term performance advantage that value stocks have shown over glamour stocks.

What about corporate bonds?

Is there a way to distinguish a value bond from a glamour bond? And which type of bond has delivered superior returns in the past?

Valuation measures such as price-to-book (P/B), price-to-earnings (P/E), and price-to-cash flow (P/CF) ratios can be applied easily to stocks to segment them into value and glamour categories. However, in the corporate bond market, value securities are more difficult to define. And the convention of referring to fixed income securities as “value bonds” or “glamour bonds” hasn’t been widely adopted.

Without a systematic way to segment corporate bonds into value and glamour categories, we went back to our study of equities.¹ We looked at the companies we grouped into various value and glamour deciles based upon *equity* valuation measures. Then we studied the *bonds* that these companies had issued and looked for any historical performance patterns among them.

SORTING BONDS INTO VALUE AND GLAMOUR DECILES

To summarize the methodology we applied in our equity study, we divided a broad universe of companies into deciles based on P/B ratios as of April 30² for each year in our study (1968 – 2006). Stocks with the highest P/B ratios were grouped in decile 1. For each consecutive decile, P/B ratios decreased; this culminated in stocks with the lowest P/B values forming decile 10. The lower deciles represented glamour stocks. The higher deciles – those filled with lower P/B stocks – represented value.

For our study of bonds, we started with the companies assigned to the P/B deciles described above, made some modifications specific to a universe of corporate bonds, and then looked at the subsequent returns of bonds (if applicable) issued by these firms. Our modifications were:

- We started our study of bonds on April 30, 1990, the first year for which we could obtain robust, issue-specific data, including performance.

¹ For a complete description of the methodology and results, please see *Value vs. Glamour: Updated and Expanded*, published in September 2006 and available at www.brandes.com/institute.

² We formed decile sets as of April 30 to capture the previous year’s reported, fundamental data.

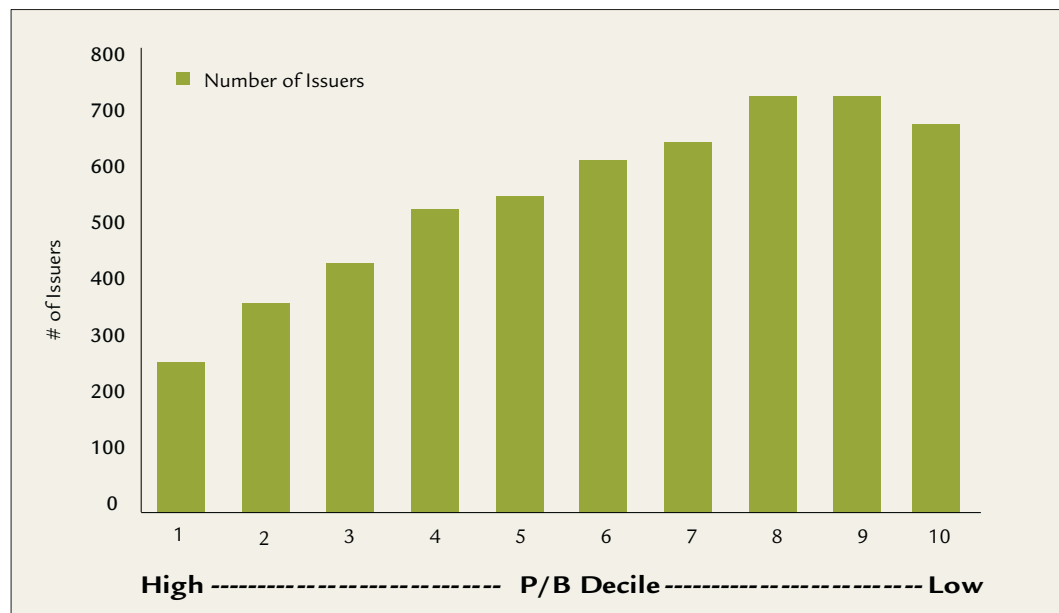
- We excluded preferred stocks, convertible bonds, and bonds with puts or calls.
- We established a minimum term to maturity of one year.
- We excluded Yankee bonds and debt of Canadian issuers.
- We restricted our analysis to companies comprising our U.S. large-cap equity sample, which generated a total of 15,770 observations over the entire study period.

Of those 15,770 observations, 5,486 had bonds outstanding during our study period; these 5,486 observations were responsible for 10,892 issues. The average term to maturity for our universe of 10,892 issues was 6.95 years. We ran our study through April 30, 2007, as 2004 was the most current year for which 3-year subsequent performance data was available.

COMPOSITION OF OUR CORPORATE BOND UNIVERSE

Generally, there were more issuers with debt outstanding within the value deciles. See Exhibit 1. This did not prove surprising as value companies tend to have greater debt issuance than their glamour company counterparts.

Exhibit 1: Companies with Debt Outstanding, Ranked by P/B Decile (1990 - 2004)



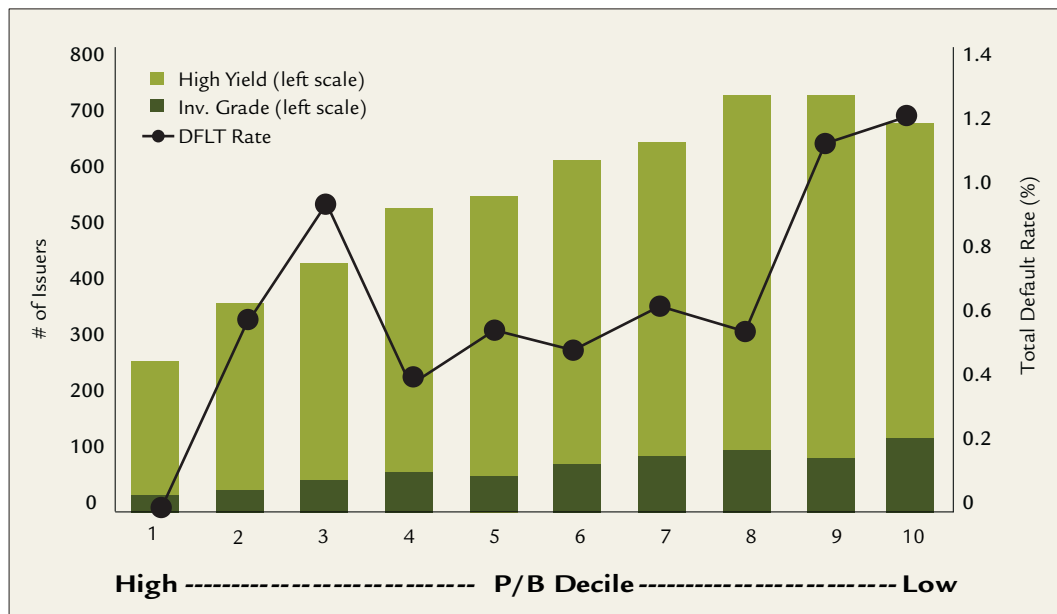
Source: FactSet; The Brandes Institute, as of 4/30/04 (the last group of decile sets was formed as of 4/30/04)

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Exhibit 2 provides a breakdown of issuers' credit quality (the number of investment grade vs. non-investment grade/high yield issuers, as defined by the average rating of S&P and Moody's) within each decile, as well as total default rates. The default rates in Exhibit 2 captured *all* defaults in each decile during the entire study period.

In our *Fixed Income Falling Knives* study, we noted that the average default rate among U.S. corporate bonds increased from about 0.5% per year prior to 1983 to almost 2.0% per year post-1983. Given these annual statistics, we believe the total default rates among the value bond issuers was within historical norms. For more information about default rates for corporate bonds, see our *Fixed Income Falling Knives* study, published in October 2006 at www.brandes.com/institute.

Exhibit 2: Number of High Yield and Investment Grade Issuers and Default (DFLT) Rates, Ranked by P/B Decile (1990 - 2007*)

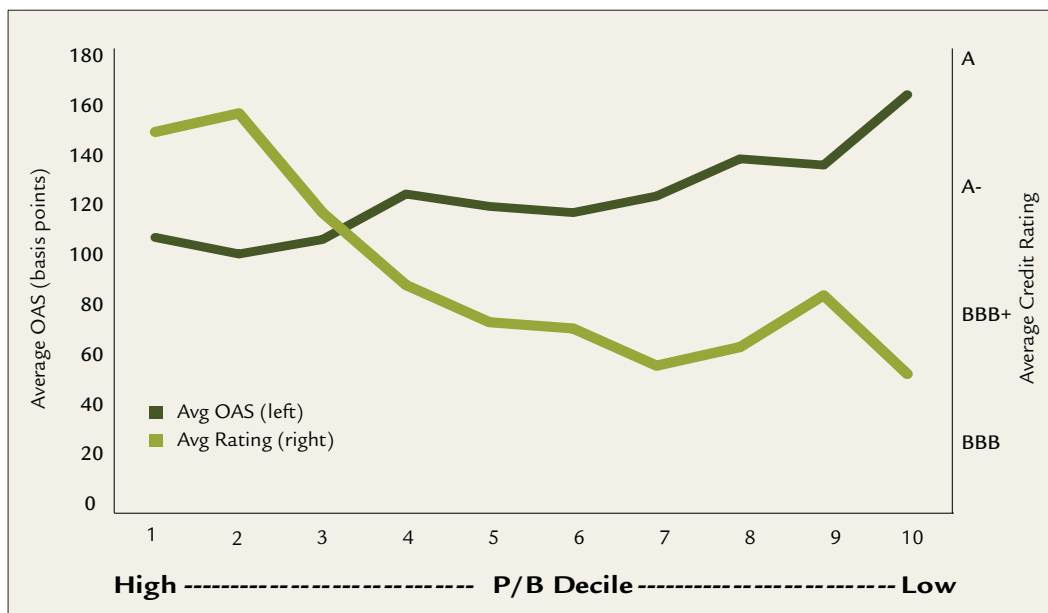


*Source: FactSet; the Brandes Institute; the number of high yield and investment grade issuers are as of 4/30/04 (the last group of decile sets was formed as of 4/30/04); the default rate reflects all defaults during a 3-year period after the issue entered the universe through 4/30/07

Not surprisingly, bonds issued by value companies tended to have greater average option-adjusted spreads³ (OAS) and lower average credit ratings vs. those issued by glamour companies. See Exhibit 3. All three measures (P/B, OAS, and credit rating) reflect perceptions of issuer-specific conditions that may affect the interests of equity and debt holders.

³ OAS reflects the application of option pricing techniques that adjust for a fixed income security's optionality. The OAS helps investors compare bonds with options to those without options.

Exhibit 3: Average OAS and Credit Rating, Ranked by P/B Decile (1990 - 2004)



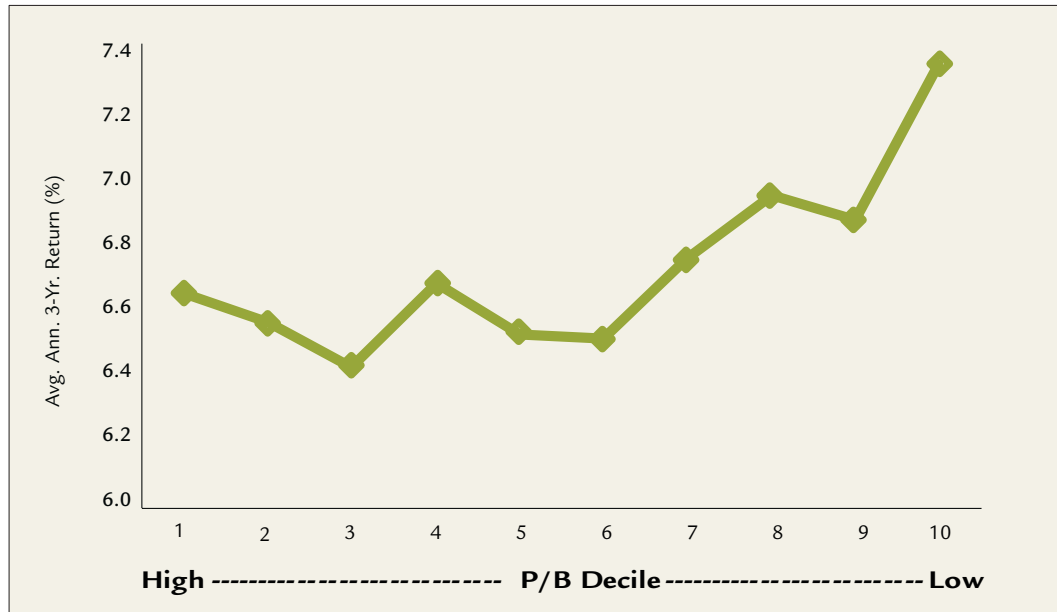
Source: FactSet; The Brandes Institute, as of 4/30/04 (the last group of decile sets was formed as of 4/30/04)

SUBSEQUENT PERFORMANCE

As shown in Exhibit 4, bonds issued by companies in the value deciles tended to deliver better total returns than bonds issued by glamour companies over subsequent 3-year periods from April 30, 1990 through April 30, 2007. While some investors may perceive issuers in the value deciles to have greater risk, given their higher default rates and lower average credit quality, Exhibit 4 illustrates the greater opportunity for enhanced returns available among these issuers during our study period.

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Exhibit 4: Average Annualized 3-Year Returns of Bonds, Ranked by P/B Decile (1990 - 2007)



Source: FactSet; The Brandes Institute, as of 4/30/07

Of course, one might argue that the value bonds' total return advantage over glamour bonds simply reflected value bonds' lower average credit rating and higher average spread during our study period. To test this notion, we compared annualized 3-year returns for the Lehman Brothers U.S. Aggregate Corporate A Index (a proxy for decile 1 bonds, whose average credit rating was approximately "A") against the Lehman Brothers U.S. Aggregate Corporate BAA Index (a proxy for decile 10 bonds, whose average credit rating was "BBB+") over the same test period as our study (April 30, 1990 - April 30, 2007).

The difference in total return between these indices was approximately 14 basis points during our study period – far less than the roughly 69-basis point annualized total return advantage decile 10 bonds showed vs. decile 1 bonds over 3-year time horizons. We believe this finding helps confirm evidence of a total return advantage for value bonds that was not fully explained by credit quality or yield spread.

CONCLUSION

We realize that there are a number of factors for which we did not account or control in this study, including but not limited to interest-rate fluctuations and corresponding cycles of spread widening or tightening, a more thorough account of differences in credit ratings and their correlations with returns, and segmenting the universe using other common measures of equity valuation such as

price-to-tangible book, price-to-earnings, or price-to-cash flow. However, our objective was not to be exhaustive, but to conduct a preliminary study of return patterns among bonds issued by value and glamour companies – as defined from the perspective of an equity holder. The results suggest that bonds issued by value companies have provided greater appreciation than those issued by glamour companies. Often, value companies are out of favor with investors, perceived to have low-return potential, and may be deemed less attractive than glamour companies. Our findings suggest the bonds issued by value companies may merit greater consideration among fixed income investors seeking competitive long-term total return.

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Stock and bond prices will experience market fluctuations. Please note that the value of government securities and bonds in general have an inverse relationship to interest rates. Bonds carry the risk of default, or the risk that an issuer will be unable to make income or principal payment. There is no assurance that private guarantors or insurers will meet their obligations. The credit quality of the investments in a portfolio is no guarantee of the safety or stability of that portfolio.

The Lehman Brothers U.S. Aggregate Corporate A Index is an unmanaged index consisting of U.S. dollar-denominated corporate bonds. Index constituents are rated by the following rating agencies: Moody's, S&P, or Fitch. When all three of these agencies rate an issue, a median or "two out of three" rating is used to determine Index eligibility by dropping the highest and lowest rating. When a rating from only two agencies is available, the lower ("more conservative") of the two is used. When a rating from only one agency is available, that rating is used to determine Index eligibility. For inclusion in this index, the issue rating must be A+/A1, A/A2, or A-/A3. Please note that all indices are unmanaged and are not available for direct investment.

The Lehman Brothers U.S. Aggregate Corporate BAA Index is an unmanaged index consisting of U.S. dollar-denominated corporate bonds. Index constituents are rated by the following rating agencies: Moody's, S&P, or Fitch. When all three of these agencies rate an issue, a median or "two out of three" rating is used to determine Index eligibility by dropping the highest and lowest rating. When a rating from only two agencies is available, the lower ("more conservative") of the two is used. When a rating from only one agency is available, that rating is used to determine Index eligibility. For inclusion in this index, a issue rating must be BBB+/Baa1, BBB/Baa2, or BBB-/Baa3. Please note that all indices are unmanaged and are not available for direct investment.

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