

Investment Theme

USD

Finding equity-like returns in corporate bonds

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At a glance

The deep-frozen credit markets have led to a significant widening of credit spreads and a historic re-pricing of corporate bonds. As a result, we believe investors willing to assume some degree of risk may potentially earn total returns in excess of 10% by selectively investing in fundamentally healthy issuers that were squeezed by the tight credit markets.

In this Investment Theme, we aim to highlight some issuers that carry a higher degree of risk, but, in return, offer what we view to be equity-like total return opportunities. As a result, we view these recommendations as appropriate for traditional equity investors as well as those fixed-income investors with a higher risk tolerance.

Banks and Brokers

- We believe the government erred when it failed to affect a rescue for Lehman; we do not expect this kind of error to be repeated.
- On 14 October, Treasury announced plans to take equity stakes directly in healthy banks.
- We think Treasury's recapitalization plan for financial institutions should insulate creditors from losses.
- We view the bonds of Bank of America, Citigroup, Goldman Sachs and Morgan Stanley as offering the best risk/reward opportunities.

Industrials and non-Bank Financials

- The stress in the credit markets extends well beyond Financials, hitting bond issuers whose businesses are linked to housing, employment and consumer spending especially hard.
- We see favorable long-term opportunities in the bonds of American Express, AT&T, General Electric, Home Depot, IBM and Kraft.

Please note: All prices and yields presented in this Investment Theme are those from close of business on 13 October 2008.

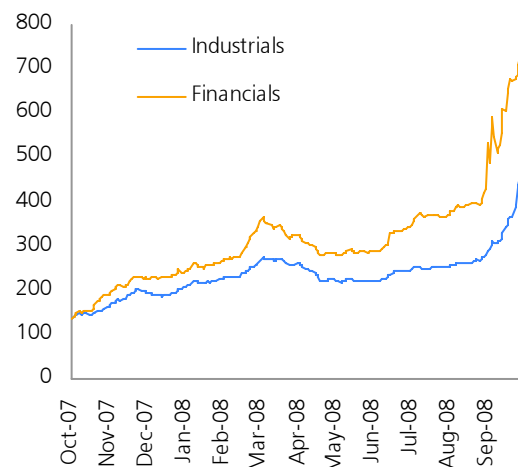
The frozen credit markets have led to a significant widening of credit spreads and a historic re-pricing of corporate bonds. Given current market dislocations, investors can purchase bonds of relatively strong, investment-grade issuers at significant discounts to par. In our view, this presents a significant opportunity for capital appreciation. In addition, with coupons generally in the 5% to 8% range, these investments generate a steady income stream. Overall, investors willing to assume some degree of risk may potentially earn total returns in excess of 10% by holding these bonds to maturity; whereas 18 months ago, investors could expect returns of only 4%-5% from the bonds of these same issuers. Nearer-term spread compression could lead to even higher returns over a shorter period of time.

WMR Bond Recommendations focus on safety and stability, believing that capital preservation is the primary goal of fixed-income investors. However, in this Investment Theme, we highlight some issuers that

Asset Class: Bonds

Credit Spreads (bps)

Credit spreads for bonds of Financial sector issuers have widened out at a faster rate than those for Industrial sector issuers



Source: Lehman Live, UBS WMR, as of 14 October 2008

Summary of Issuers

Though we provide representative bond issues in this report, we feel that all senior unsecured debt of these issuers present compelling opportunities for investors willing to tolerate some risk.

Banks and Brokers

Bank of America, including Countrywide and potentially Merrill Lynch
Citigroup
Goldman Sachs
Morgan Stanley

Industrials and non-Bank Financials

American Express
AT&T
General Electric
Home Depot
IBM
Kraft

Source: WMR, 14 October 2008

carry a higher degree of risk. In return, we think they offer equity-like return opportunities.

We note that volatility is likely to persist in credit markets, and loss of principal is possible. Therefore, we view many of these opportunities as **appropriate only for investors with a higher risk tolerance**. For those with a more conservative risk profile, please see our regularly updated Bond Recommendations publications.

Banks and Brokers

We attribute much of the turmoil in the credit markets to the fallout from the Lehman bankruptcy. In the weeks that followed, both long- and short-term debt markets have come to a near standstill. We believe that the government made a mistake and underestimated the effects of not facilitating some sort of rescue for Lehman. We do not believe this mistake will be repeated. Rather, it is our view that the future model for dealing with a large, failing financial institution will more closely resemble that used for Bear Stearns, AIG and to some extent Fannie Mae and Freddie Mac. In each of these instances, the government stepped in to support the company and its bondholders, with most or all equity being wiped out.

Support from the government can take a variety of forms. One example is explicit support to private investors looking to recapitalize a financial institution, such as the backstop and loss provisions extended to JPMorgan in order to facilitate its acquisition of Bear Stearns. Such a model enables a private-sector solution, albeit one backed with taxpayers' dollars.

On 14 October, Treasury announced plans to provide capital to healthy banks in exchange for preferred shares. Nine of the largest financial US institutions will receive USD 125 billion, while an additional USD 125 billion will be used to recapitalize smaller financial institutions. While the full effects of this action should take some time to emerge, we expect that it will help to stabilize the banking system, and we view this measure as another important step in restoring order to the credit markets.

As we move through the next few months, we believe the combination of these methods, both recapitalization and nationalization of financial institutions, will insulate creditors and protect them from losses. With this in mind, we believe it is appropriate now for bond investors with an appetite for risk, as well as for traditional equity investors, to consider investing in Financials through the purchase of senior unsecured bonds. Given our belief that bondholders will be protected in the future while equity holders may not be, these investments offer reasonable downside protection.

Below, we highlight the Financial sector bond issuers that we believe offer the most attractive investment opportunities. We expect each of these issuers to survive the current turmoil because, in our view, they are too enmeshed in the workings of the financial system to be allowed to fail. Further, we believe that, if recapitalized, each has the earnings generation potential to operate profitably in the future.

Bank of America

Overall, we feel comfortable with Bank of America's current fundamental profile, but recognize that the company has added risk over the past nine months with the acquisition of Countrywide and Merrill Lynch. Despite raising nearly USD 10 billion in new equity recently, and

reducing its dividend, we think more capital will be needed, which would be a positive for the credit. With Bank of America's high exposure to the US consumer, the near-term outlook remains challenging. Still, given its growing footprint and importance to the US banking industry, we view Bank of America as a primary beneficiary of the Treasury recapitalization plan.

Representative bond issue:

Bank of America Corp 5.65% due 5/1/18.

CUSIP: 06051GDX4 Price: 81.0 Yield to Maturity: 8.6%

Citigroup

Much like Bank of America, we view Citigroup as highly important to the US banking system and we believe it, too, will be a primary beneficiary of government plans to stabilize the financial system. There is much heavy lifting to do as Citigroup attempts to shed non-core businesses, reduce risk, and stabilize its balance sheet. The execution risk associated with these activities is the reason why Citigroup's bonds trade well below its AA-rated peers. Credit quality may continue to weaken as net credit losses and non-performing assets increase. While financial results may be uneven over the next few quarters, leading to further volatility for the company's bonds, we view default risk as low.

Representative bond issue:

Citigroup Inc. 6.125% due 5/15/2018

CUSIP: 172967ES6 Price: 79.8 yield to Maturity: 9.37%

Goldman Sachs and Morgan Stanley

Recent negative rating actions by Moody's, although overdue, have been offset by fresh capital raised from large and respected investors, with Warren Buffett purchasing a stake in Goldman Sachs, and Mitsubishi investing in Morgan Stanley. Still, we view the broader market's lack of confidence in the traditional wholesale-funded investment banking model as worrisome. We await these issuers making use of their new bank holding company status to stabilize their sources of funding. For both, we expect the next few years to be challenging as they struggle with a new business mix, changing funding models and the weakening economic environment. While it is probable that both will be less profitable over the next few years, we believe that their current capital and liquidity positions should enable them to weather the storm and emerge as profitable, albeit less leveraged, businesses.

Representative bond issues:

Goldman Sachs Group Inc. 6.15% due 4/1/18.

CUSIP: 38141GFM1 Price: 82.1 Yield to Maturity: 9.00%

Morgan Stanley 5.375% due 10/15/15

CUSIP: 61746SBR9 Price: 53.5 Yield to Maturity: 16.98%

Industrials and non-Bank Financials

The stress in the credit markets extends well beyond the Banks and Brokers, most acutely affecting those issuers exposed and correlated to a litany of joyless data points, including housing, employment and consumer spending. As a result, we have identified a number of issuers that we believe offer extremely attractive long-term opportunities, as spreads have widened dramatically though we see little likelihood of significant deterioration in their fundamentals. These include:

American Express

Certainly, many operating trends do not bode well right now. Rising unemployment as well as further declines in housing could lead to deteriorating asset quality. However, we dispute recent concerns that dislocations in the commercial paper market could cripple the company's operating ability. American Express enjoys ample liquidity and has curtailed share repurchases in order to conserve capital. While delinquencies and loss rates may rise, it is our view that default risk remains extremely low.

Representative bond issue:

American Express 7% due 3/19/18

CUSIP: 025816AY5 Price: 86.7 Yield: 9.13%

AT&T

Operating results have been broadly favorable despite a number of challenges, most notably a weakening economy. Fewer housing starts and rising foreclosures may lead to weakness in the consumer segment. Still, we believe with improving margins and a commitment to reducing debt with free cash flow while reducing share repurchases, AT&T will enhance its already solid credit profile. Weakness in the telecom sector, stemming largely from funding concerns, is less relevant for AT&T, as the company has manageable debt maturities.

Representative bond issue:

AT&T Inc. 5.5% due 2/1/18

CUSIP: 00206RAJ1 Price: 80.29 Yield: 8.62%

General Electric

GE's robust credit quality reflects its leading global market positions across a broad range of businesses, its strong free cash flow generation and financial flexibility. GE's bonds have fallen recently, mainly due to investor concerns over funding issues at GE Capital Corp. (GECC), which contributes about 50% of GE's profits, given GECC's reliance on wholesale funding. However, unlike the portfolios of many banks and brokerages, the vast majority of GECC's assets are originate-to-hold rather than originate-to-sell, which mitigates large quarterly mark-to-market swings and reduces the probability of large asset write-downs. The company has also taken prudent steps, in our view, to improve its liquidity, issuing common and preferred stock and reducing its reliance on commercial paper funding. Despite our expectations for higher delinquencies and loan loss provisions in 2009, leading to declining profits, we view GE as low-risk, noting that roughly 55% of GE's profits come from its healthy industrial businesses (NBC Universal, Infrastructure, Health Care, & Industrial).

Representative bond issue:

General Electric Capital Corp 5.625% due 5/1/18

CUSIP: 36962G3U6 Price: 86.75 Yield to Maturity: 7.60 %

Home Depot

Home Depot is a well-established leader in the home improvement retail industry. We feel the intense pressures on the industry could last well into 2009 with the near-term industry outlook becoming even more competitive. However, we believe Home Depot will take advantage of the current industry downturn to increase its market share. A favorable cash-flow outlook, strong focus on cost-containment and minimizing capital expenditures, and a relatively good liquidity position should help to solidify Home Depot's market-leading position. The largest risks include a worsening housing market in the near term, or a

delayed US economic recovery.

Representative bond issue: Home Depot 5.4% due 3/1/2016
CUSIP: 437076AP7 Price: 71.5 Yield to Maturity: 11.17%

IBM

WMR views IBM's credit trend as Stable. While customer spending is likely to decline next year globally, IBM's high level of recurring revenue should, in our view, help it to weather the storm better than most. Interestingly, the turbulence in the financial markets could serve to strengthen IBM's market position, as financial institutions are likely to reduce the number of vendors they use in favor of the larger ones. A major risk for IBM remains the possibility of a large acquisition that negatively impacts its capital structure. Still, we would expect such a transaction to be prudently funded. With low-single-digit revenue growth, we think capital preservation and maximization of cash flow are likely to be prioritized.

Representative bond issue: IBM 7.625% due 10/15/2018
CUSIP: 459200GM7 Price: 99.0 Yield to Maturity: 7.7%

Kraft

Kraft has leading market share in a broad range of food categories. It is in the midst of a turnaround effort that aims to restore earnings growth by investing in its top categories. We expect free cash flow to improve as the program draws to a close. Rising commodity costs have pressured earnings, but Kraft is working to offset the impact via higher prices and productivity. Principal risks to its credit outlook include the potential for debt-financed acquisitions and a possible slowing of sales and profit growth if US consumers trade down to cheaper, private label products in light of the weakening economy.

Representative bond issue: Kraft 6.125% due 8/23/18
CUSIP: Price: 88.9 Yield to Maturity: 7.75%

[Back to "At a glance"](#)**Statement of Risk**

Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables.

Corporate bonds are subject to a number of risks, including credit risk, interest rate risk, liquidity risk, and event risk. Though historical default rates are low on investment-grade corporate bonds, perceived adverse changes in the credit quality of an issuer may negatively affect the market value of securities. As interest rates rise, the value of a fixed coupon security will likely decline. Bonds are subject to market value fluctuations, given changes in the level of risk-free interest rates. Not all bonds can be sold quickly or easily on the open market.

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Appendix

Credit Issuer/Bond Recommendation Definitions				
Recommendation	Time Horizon		WMR Terminology	Definition
WMR Credit/Bond* Rating	Longer Term	Investment Grade	AAA	Issuer / Bonds have exceptionally strong credit quality. AAA is the best credit quality.
			High AA	Issuer / Bonds have very strong credit quality.
			Mid AA	
			Low AA	
			High A	Issuer / Bonds have high credit quality.
			Mid A	
			Low A	
			High BBB	Issuer / Bonds have adequate credit quality. This is the lowest Investment Grade category.
			Mid BBB	
		Low BBB		
		Non-Investment Grade	High BB	Issuer / Bonds have weak credit quality. This is the highest Speculative Grade category.
			Mid BB	
			Low BB	
			High B	Issuer / Bonds have very weak credit quality.
			Mid B	
			Low B	
			High CCC	Issuer / Bonds have extremely weak credit quality.
			Mid CCC	
Low CCC				
CC	Issuer / Bonds have very high risk of default.			
C				
D	Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.			
WMR Credit Trend		Improving	The WMR Credit Trend reflects the analyst's expectation that the company's credit fundamentals will improve.	
		Stable	The WMR Credit Trend reflects the analyst's expectation that the company's credit fundamentals will remain stable.	
		Deteriorating	The WMR Credit Trend reflects the analyst's expectation that the company's credit fundamentals will deteriorate.	
	Review within a couple of months	Watch +	Increased likelihood of WMR Credit Rating upgrade(s).	
	Review within a couple of months	Watch -	Increased likelihood of WMR Credit Rating downgrade(s).	
Recommendation	WMR Terminology		Definition	
Bond Recommendation	Outperform (OUT)		The bond is expected to earn a higher total return than a liquid bond benchmark representing a comparable level of risk.	
	Marketperform (MKT)		The bond is expected to earn a total return in line with a liquid bond benchmark representing a comparable level of risk.	
	Underperform (UND)		The bond is expected to earn a lower total return than a liquid bond benchmark representing a comparable level of risk.	
	Sell (SELL)		In light of substantial downside credit or default risk, and the expectation of a lower total return than a liquid bond benchmark representing a comparable risk, investors should sell these bonds.	

*The Bond Rating reflects WMR's opinion of the credit quality of a bond. The WMR Bond Rating is derived by adjusting the WMR Credit Rating of the issuer for any collateral-type and capital structure considerations specific to that bond. This may result in the bond having a different risk profile, and therefore a different rating than the issuer, as well as other bonds of the issuer.

Appendix

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