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FridsonVision HIGH YIELD STRATEGY

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Publisher

Fair Value Model Update

After moving closer to fair value in February through April, high yield suddenly swung back to extreme overvaluation during the first half of May. Read below the factors we use for calculating fair value, followed by the details of this abrupt shift.

Credit Tightness

The percentage of banks tightening credit for medium- and large-sized companies minus the percentage of banks easing credit for those borrowers, as reported in the Federal Reserve Board of Governors in its quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices.

Industrial Production

Month-over-month change reported by the Federal Reserve Board of Governors.

Five-Year Treasury Rate

Effective yield on the ICE BofA Current 5-Year US Treasury Index

CCC & Lower Percentage

Percentage of the total face amount of the ICE BofA US High Yield Index with a Composite Rating of CCC or Lower.

For portfolios that include high yield bonds along with other asset classes, we recommend underweighting (overweighting) high yield when the actual OAS exceeds (falls short of) the model-estimated value by one standard error or more.

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FridsonVision High Yield Strategy is a bi-weekly research service produced by FridsonVision LLC and geared to finance professionals. Its publisher is Martin Fridson, CFA, who was the #1 Institutional Investor All America Research High Yield Strategist while at a leading investment bank and is an inductee to the Fixed Income Analysts Society Hall of Fame.

Current Factor Values

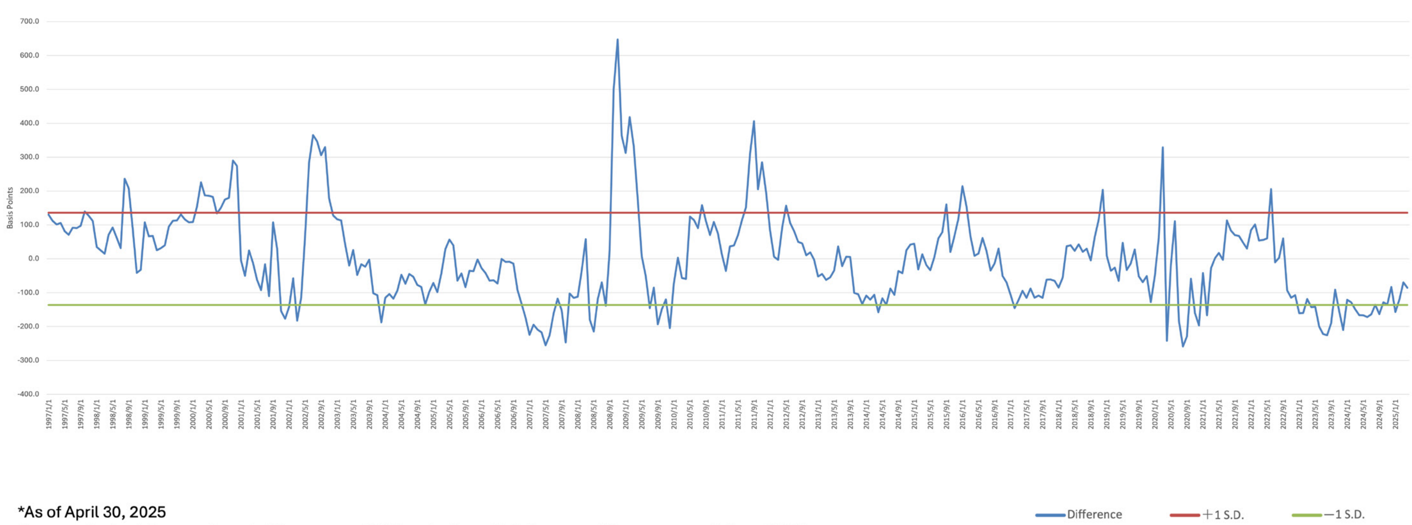
One standard error, our cutoff for deeming the high yield asset class extremely overvalued, equates to a differential of -136 basis points (bps) between the actual high yield OAS and our model-generated fair value spread. As of May 16, 2025 the gap is once again in extreme overvaluation territory. Let us briefly review how the market got there.

On January 31, 2025 the high yield market was in a state of extreme overvaluation. The actual OAS was just +268 bps, the fifth narrowest spread in the series' 340-month history. Fair value stood at +425 bps, for a difference of -157 bps.

Over the next three months the actual OAS widened all the way to +394 bps. Fair value had meanwhile increased to +479 bps. The net effect was that the Actual-minus-Fair-Value gap ended April at -85 bps, tighter than fair value but not extremely so, according to our one-standard-error criterion.[1]

Between April 30 and May 16, however, the actual spread on the ICE BofA US High Yield Index contracted dramatically, from +394 bps to just +316 bps. That put it within 50 bps of its historically narrow level of January 31. First-half-May's move paralleled a 6.99% gain by the S&P 500 and reflected a major easing of trade tensions between the U.S. and China. On May 12 the two countries agreed to hold off for 90 days on raising tariffs on each other to over 100% while continuing their negotiations on the levies.

High Yield Spread: Actual minus Estimated Monthly, January 1997- April 2025



*As of April 30, 2025
Sources: Federal Reserve Board of Governors; ICE Data Indices, LLC; Leveraged Commentary & Data (LCD)

Fair Value Model Update

For now, high yield bond valuations are severely out of whack with the yield premium that would fairly compensate them for risk, based on the fundamental determinants of the spread. There are two ways by which we can envision the risk premium coming into line with risk in the reasonably near term. One is for bank lenders to move back significantly in the direction of less credit tightness. The other, less favorable for high yield bondholders, is for the actual spread to widen substantially from its May 16 level.

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[1]Between March 31 and April 30, fair value increased from +425 bps to +479 bps. The key factor was an increase in Credit Tightness. According to the April update of the Federal Reserve's quarterly survey of senior bank loan officers, the percentage of banks tightening standards for medium-sized and large companies to qualify for loans, minus the percentage easing standards, jumped from 6.15% to 18.40%. Also driving the fair value OAS higher were:

(a) A drop in the five-year Treasury yield, which is inversely correlated with the spread, from 3.95% to 3.72%.

(b) A slight increase in the CCC & Lower percentage of the high yield index's face amount from 13.26% to 13.30%.

Those pro-widening effects were partly offset by an improvement in Industrial Production from -0.30% to 0.00%.

Martin Berman, High Yield Pioneer

History isn't just written by the victors—it's often edited by the spotlight. In the story of high yield finance, one name commands the stage while others, equally instrumental, stand in the wings. This is not a tale of rivalry or revisionism, but of recognition overdue: an invitation to look again, and look closer, at the quiet architect behind a financial transformation.

Speculative grade issuers of the early-to-mid 1970s did not generally include small, Single-B-rated companies.

Martin Lawrence Berman (May 6, 1940-April 16, 2018) is not listed in the index of Connie Bruck's *The Predators' Ball* or Jesse Kornbluth's *Highly Confident*, two prominent books about the rise of the high yield bond market. By contrast, Michael Milken's listing in Bruck's index contains 87 subheads, including "as the King" and "as 'national treasure.'" Kornbluth's index lists 71 subheads for Milken.

Milken certainly deserves wide recognition for his leadership in the noninvestment grade corporate market's transformation from a financial backwater to a mainstream investment category. The largely unheralded Marty Berman, though, was much more than a footnote to the story. My thanks to Drexel Burnham Lambert alumnus (1985-1990) Dennison "Dan" T. Veru for describing Berman's key role in the development of the high yield new issue market.

The traditional account is that up until the late 1970s all high yield bonds were fallen angels, issued with investment grade ratings and subsequently downgraded to speculative grade. In reality, there was a small annual trickle of below-Triple-B underwritings in the early 1970s. Former Drexel banker Phil Friedman points out, however, that those bonds were overwhelmingly obligations of large, Double-B or split-rated (Triple-B/Double-B) companies. (In 1971, however, Eastman Dillon underwrote a $30 million offering by B/NR American Finance System.) The breakout that ultimately led to annual new issuance totaling on the order of $400 billion a year consisted of gaining widespread acceptance of offerings by small companies rated Single-B.

Martin Berman, High Yield Pioneer

Veru is Chief Investment Officer of Palisade Capital Management, a firm founded by Marty Berman and his brother Steven. He says Milken's concept of expanding Drexel's franchise from the secondary to the primary market consisted of restructuring the debt of large corporations that found themselves in financial straits. Marty Berman had a different idea.

Starting as a stockbroker at Burnham & Co. in the 1970s, Berman wondered why his fellow brokers were so eager to leave work by late afternoon. Not married and financially well set, he began to travel the country visiting smaller companies in search of new investment opportunities. By the time Drexel Burnham was looking for high yield underwriting clients, he had developed relationships with many excellent prospects.

Berman brought to Drexel's attention the appetite for capital among small companies that found equity financing unappealing.

As Burnham explained to Milken and the bankers, these companies' stocks were not widely followed by Wall Street analysts and sold at price-earnings multiples as low as 4x-5x. They needed to raise capital but were understandably unenthusiastic about selling stock at such meager valuations. As I documented in a 1993 Merrill Lynch report, the companies did have access to the private placement debt market.[1] Executives of early high yield issuers told me, however, that they found the restrictive covenants in private debt and bank loans onerous. Less restrictive public high yield bonds, which had the further advantage (from the issuer's standpoint) of typically being subordinated to other debt, represented an attractive alternative. Investors got less covenant protection and a more junior position, but the promise of liquidity via an active secondary market, a benefit not offered by private placements or loans at that time.

Berman's pivotal role in making smaller companies that were seeking growth capital, rather than troubled large corporations in need of balance sheet repair, the focus of Drexel's underwriting effort is not reported in the abovementioned books, but neither is it contradicted by anything in those narratives. Kornbluth's account focuses on Drexel investment banking chief Fred Joseph's role and on Milken's criticism of an LTV issue that preceded Drexel's first deal. Bruck likewise highlights the role of Joseph, who said that prior to his connecting with "the bright guy down on the trading floor doing deep-discount bonds," Milken "didn't know anything about banking."[2]

Before Drexel got into the game in 1977, Bruck notes, Lehman Brothers Kuhn Loeb underwrote several below-investment grade deals. The issuers were by no means small, obscure companies. They included Pan American World Airways and their deal sizes ranged from $53 million to $75 million. Drexel's out-of-the-gate 1977 issues, by contrast, ranged from just $12.5 million to $30 million in offering amount.

[1]Martin S. Fridson and Jeffrey A. Bersh, "*What Caused the 1977-1978 Takeoff in High Yield Finance?*" Extra Credit (Merrill Lynch & Co.), pp. 4-25

[2]Connie Bruck, *The Predators' Ball: The Inside Story of Drexel Burnham and the Rise of the Junk Bond Raiders*, p. 44.

Bruck does not say where the idea of underwriting bonds for smaller companies originated. It is worth noting, however, that the fallen angels that Milken was trading in prior to Drexel's entry into the high yield new issue business were by their nature larger companies of the sort that Lehman Brothers Kuhn Loeb had underwritten. (Milken also did a brisk business in troubled Real Estate Investment Trusts.) The smaller companies among Drexel's 1977 issuers included Berman relationships such as Comdisco and Michigan General. Later on, Berman brought in such prominent clients as MCI Communications and Pier I Imports.

Phil Friedman was the junior banker on the Michigan General deal. He fondly remembers Marty Berman hosting him at his beach house on beautiful Peconic Bay. Once the idea of underwriting deals for small companies emerged at Drexel, Friedman was assigned to identify candidates to solicit through a computer search by an outside vendor utilizing three financial metrics. He also recalls that Berman, uniquely among the firm's retail brokers lodged on a lower floor, met with Joseph in his 37th-floor office.

How Has This Story Gone Untold?

Some readers may be skeptical that of this report's thesis that Marty Berman made an essential contribution to a profound change in the capital markets, yet his name is unknown to most individuals who made their careers out of that change. The name Marty Berman is similarly unlikely to be recognized by the legions of individual investors who have prospered by owning high yield bond mutual funds, most of whom have probably heard of Michael Milken. Students of history, however, will not find the disconnect surprising.

Those who are familiar with how history works will not be surprised that a contribution as profound as Berman's has been overlooked.

Consider, for example, the history of invention. There are many famous inventors, but few things have gotten invented *ex nihilo*. Rather, a particular technology advances through a series of discoveries and then a breakthrough occurs that immortalizes a Gutenberg or Marconi. Few people know the name of Elisha Gray, who filed a telephone patent on the same day as Alexander Graham Bell.

Michael Milken deserves the fame he gained through his tireless efforts to bring high yield investing into the mainstream. Whatever picture the media may present, however, the creation of the modern high yield new issue market was not a one-man production. As detailed above, Fred Joseph's role is well documented. Other Wall Street firms underwrote speculative grade issues before Drexel showed up in the league tables. Drexel did tweak the formula by focusing on smaller companies, but that was Marty Berman's idea rather than Milken's.

Further underscoring the point about multiple innovators is another comment by Dan Veru. Milken is now associated with financing leveraged buyouts, with former U.S. Labor Secretary Robert Reich recently excoriating him for that activity and the economic problems Reich believes resulted from it.[3] Veru says, however, that it was Leon Black's idea to use high yield bonds to bankroll LBOs. Bruck merely states that Black "headed the LBO group"[4] at Drexel.

In a phrase popularized by John F. Kennedy but with precedents dating back to Tacitus, "Success has a thousand fathers but failure is an orphan." The pioneers responsible for the stunning success of the high yield new issue market number fewer than a thousand, but certainly more than one. It is high time that Marty Berman was more widely recognized for playing a highly important role.

[3]See https://robertreich.substack.com/p/how-the-corporate-raiders-caused This article is cited solely to document the popular perception of Michael Milken's association with corporate raiders.

[4]Bruck, p. 100.

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