



KRASNEY FINANCIAL PRESENTS:

FINANCIAL ARTICLE FOR THE MONTH OF NOVEMBER 2008



WHY WE ADDED HIGH YIELD OUR REASONING AND THOUGHTS

INTRODUCTION

The bear market we've been experiencing has affected more than just equities. Among these, high-yield (junk) bonds have suffered big declines. Last week we added an initial position of high-yield bonds in select accounts. Since risk characteristics are somewhere between stocks and bonds, we compare its potential returns to a blend of those asset classes. We think high yield returns are attractive even relative to pure equities. The most referenced data point for analysts is yield spreads versus Treasuries. If high yield offers a huge yield premium, then it's typically judged to be cheap. The problem in relying solely on this approach is:

1. Spreads are a function of the yield on junk bonds and the yield on Treasuries. If the spread is abnormally high, it could be partially because Treasury yields are abnormally low.
2. If there is a significant risk based on deteriorating fundamentals, a higher yield is required to compensate for that risk.

When absolute yield levels are well above average, it gets our attention since it is the primary source of long-term returns. The Merrill Lynch High Yield Master Index was yielding over 18% in absolute terms, as of October 10th. We're also aware of risk and how it can take two forms: defaults and price changes. Right now, default rates are not terribly high. However, forecasts call for defaults to rise meaningfully in the coming year. In 1991 and 2002, losses from defaults peaked at around 10% and 13% respectively; in most of our scenarios, we assume defaults worse than either of the historical periods. The good news is defaults don't normally result in a complete loss. Some percentage of the loss is ultimately recovered, and our analysis factors this in as well.

Price change risk is somewhat lower when yields are already very high, as they currently are. When we look at yields years from now, the odds are yields are likely to be at least moderately lower. Whatever economic stress we're experiencing will likely have moderated five years from now. We expect price change to be a positive over the next several years, rather than a risk. We feel that the upper end in a bullish scenario could result in yields in the mid-to-high teens. Two things are striking. First, the relatively narrow range of outcomes over our five-year investment horizon. We expect that there will be volatility on a month-to-month, or even year-to-year basis. Second, pre-tax returns are equal to or better than stocks, with less volatility. This is a big part of the appeal of this asset class right now: the upside is comparable to stocks, but in a bear scenario the returns are notably better.

We appreciate the opportunity to talk with "Friends & Family" who can benefit from our services. If you know someone not happy with their current advisory relationship, or going through a "life event" we would appreciate the opportunity to be of service to them. If you provide their contact information, we will gladly reach out to them, without cost or obligation. Thank you so very much for keeping us in mind.

These views are those of Krasney Financial LLC and should not be construed as investment advice. All information is believed to be from reliable sources; however we make no representation as to its completeness or accuracy.

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HOW DO WE PLAN ON INVESTING IN HIGH YIELD

Normally, our default is to use an index fund or ETF to implement a tactical overweighting. However, there are significant issues with the available index vehicles in the case of high yield, ranging from an odd underlying index to big price-to-NAV spreads for ETFs. We decided to use actively managed funds that are typically handled in a way that keeps their returns fairly close to the benchmark.

This is a total return asset class that I truly love, and currently look upon as equal in return potential to the investments Warren Buffet recently made in GE and Goldman Sachs. We also receive both current income and upside potential in our High Yield investment, similar to the 10% income with warrants that Warren Buffet got for his investment in those two firms. Stay tuned to see what happens.

All of my best,

Jonathan

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