

Navigating for High Yields

Navigating through the high-yield sea of opportunities can be rough, as one has to be mindful of the high risk of defaults. That is why Paul Scanlon, the manager of the Putnam High Yield Advantage Fund, believes that it all comes down to sufficient expertise, resources, and a rigorous and risk-controlled process. The fund also relies on diversification and granularity to capture the opportunities and minimize the risks.

Q: What are your core beliefs in managing money?

A: We believe that to outperform in the high-yield market, it is crucial to avoid deteriorating credits, or credits with higher embedded volatility. Over a full cycle, the high-yield market has a default rate of 4.3%, which means that 4.3% of the time a bond fails to pay its obligations. In those cases, the investors typically lose about 65% of the money invested in that bond. That is why the success in the high-yield market is highly dependent on doing a good job when navigating through those areas of price erosion.

It is all about identifying the credits in transition, where the market all of a sudden determines that the business plan or the asset coverage is worse than expected. And while the skeptical aspect of our philosophy is avoiding the deteriorating credits, it is important to look for opportunities and sift for value through many securities in transition. You have to be a skeptic, but you also need to be prepared to take advantage of those movements.

Q: What is the nature and the duration of the cycles in the high yield market?

A: The high-yield market has matured a lot, and since the mid 80s, there have been only two periods with very high default rates. In general, the duration of a cycle is five to seven years and covers many different industries.

When we are coming out of the low part of a cycle with many defaults, the bond prices

are low. The market starts with higher than normal yield, the bad companies default, and go away to be reorganized. At the same time, the good companies survive and the market is very judicious and prudent about the new securities it buys. It tends to be a very selective period, where only the strong companies or the good bond structures come to market.

Because only strong companies can come to the markets, the total returns pick up, and bond defaults go down. The excess returns start to look attractive, the money flows in, and the discipline gradually erodes. Along the way, certain sectors get weak or the economy experiences problems. In such an environment, the more aggressive transactions cannot do well and the default rates start to pick up again, the returns drop, the money leaves the asset class, and the cycle begins again.

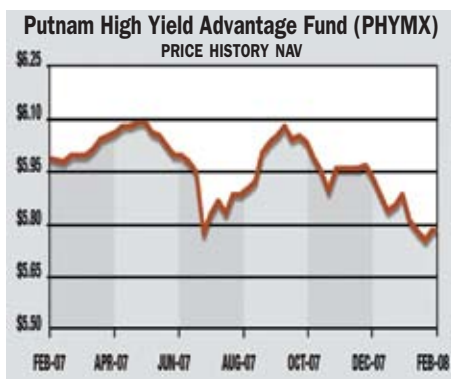
Q: How does your philosophy translate into an investment strategy and process?

A: We have a rigorous risk-controlled process and our strategy combines a top-down and a bottom-up approach. In the top-down part of our process, we make sure that we develop a general idea of the portfolio composition in terms of risks, market opportunities, and broader themes. Overall, we try to find where the value is. Based on our market outlook, the portfolio risk can be defensive, offensive, or neutral. We also make sure that we are very thoughtful about the different layers of the market, such as the higher and lower quality parts, and each sector.



PAUL SCANLON is a Managing Director and Team Leader on the U.S. Core Fixed Income High Yield team, specializing in high-yield corporate bonds. He is portfolio leader for Putnam High Yield Trust, High Yield Advantage Fund, Floating Rate Income Fund and Managed High Yield Trust. Additionally, he is a portfolio member for Diversified Income Trust, Master Intermediate Income Trust and Premier Income Trust. Scanlon joined Putnam in 1999 and is a CFA charterholder with 19 years of investment experience.

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Then we construct the portfolio on a bottom-up basis. We believe that we can add value through in-depth understanding of the industries, the companies, and the opportunities within the capital structures. If we believe that the utilities sector is attractive, we consider which companies are best positioned and whether their fundamental credit trajectory is improving, declining, or stable. We also consider the risks and the opportunities in the capital structure.

We believe a major differentiator of our process is our rigorous research platform coupled with our ingrained bias about the inherent asymmetry of high yield bonds. Bonds come to market at par and can go up to 110 or down to 0 and on average recover to 35 cents on the dollar. That is why we tend to run a more diversified portfolio. Our research platform and large research team allow us to hold more names than our peers. The idea is to make many small bets, being very mindful of the market asymmetry.

An important aspect of our strategy is that we consider not only the companies that we want to own, but also how we want to own them – as bank loans, long-dated bonds, credit derivatives, convertibles, senior or subordinated debt. Overall, there are different ways to add value to the portfolio, and we mine through the market to build positions most efficiently.

Q: Could you explain your research process in more detail?

A: I believe that the research team is one of our greatest assets. It has been together for a long time and we have been managing money in the same way. The analysts are free to examine situations in whatever way

they believe is appropriate, but we have a process that brings together the research ideas across the whole market in a comparable way.

In the top-down process, each month we review a myriad of variables and we classify them as fundamental, valuation, and technical variables. Then we score each of those variables as positive, negative, and neutral. We consider the economy, how the companies are doing, as well as the different sector-specific issues.

We consider the overall market valuation and the specific sector valuations. We compare the valuation of the high yield market to other parts of the fixed income universe, such as high grade, emerging markets, and bank loans. Then we consider the broader technical issues, such as the supply and demand balance, or the supply of new money to the market. The leverage of the companies who borrow money to invest is also important. Then we frame a strategy about our portfolio beta and the broader parameters of the portfolio.

In the bottom-up process, we have to select bonds from a universe of about 1,000 issuers. The analysts work closely with the sector portfolio managers to go through the industries, the companies, and the capital structures to figure out the best way to express our view on a given company.

We have different strategies for the different sectors, but we always ask our analysts to come back to the same key variables. They evaluate companies to rank their sustainable competitive advantage. Then they score the viability of the capital structure and evaluate the trajectory of the free cash flow. They evaluate and rank the downside protection and offer relative value opinions in comparison to other names within their sector.

The most important goal of this process is to develop a view of what do we think this company is going to look like in a year or three years and why we have confidence in that view. The focus of the research is to avoid the price erosion and to take advantage of our expertise when bonds get into transition.

Overall, ideas are generated from a lot of different sources and the tools and databases are as important as the dialog and the interaction. The key is having a decentralized and nimble process, combined with sufficient sector and capital structure expertise.

Q: Could you give us a couple of examples that illustrate your process?

A: Over the last couple of years, we have had a lot of success in energy. The driver of this view was not the direction of the energy prices, but the very attractive capital structures of the companies, which don't have much bank debt. They have been investing a lot of money into building up the reserve basis and have been hedging out their commodity exposure. Generally, we believe that these companies are underrated.

We reflect that view in a number of different ways. When there is a sector that we like, we have more flexibility to go down in the capital structure, pick up yield, and achieve potentially greater appreciation. We overweight the sector and we have come down to the riskier part of the capital structures in Chesapeake, Williams, and El Paso.

On the other hand, we have been skeptical about the homebuilders not because of the macro picture, but because it is very difficult to have a sustainable competitive advantage in such a fragmented market. In addition, the homebuilders never really deleveraged. Even at the peak of the cycle, the homebuilders were still buying up land, so weren't well positioned for any kind of a downturn. Now the downturn appears to be larger and more significant than expected, but the team did a great job of positioning us at an underweight.

Sometimes we also rely on good old-fashioned picking within an undistinguished sector. For example, we made a lot of money on Playtex, the consumer products business. Our analysts thought that it was a well-run company, which was far more valuable to an acquirer who could take out the corporate overhead and run the brands over a larger base. We had an overweight in Playtex, owning different parts of the capital structure, and we benefited from

that strategy when the company was acquired. We didn't have to sell out because the company was taken over.

Q: What are the key features of the portfolio construction?

A: We manage a diversified portfolio, where granularity is key feature. The number of issuers varies depending on the market outlook, but we may hold as many as 250 issuers. Our beta or market sensitivity is typically in the range between .95 and 1.05, but we may increase our aggressiveness when appropriate in the range of .85 to 1.15. We don't take many sector or industry sector bets, but when we do, we classify the bet as no more than 2% of the benchmark weight. .

Also, we tend to be duration neutral. The high yield market has different levels of interest rate sensitivity, so a quarter or a third of the year is duration neutral. But the most important feature of the portfolio construction process is the risk limit on what we can lose on a given name, which is 30 basis points versus our benchmark.

Q: Which benchmark do you follow?

A: We use the JPMorgan Developed High Yield Index which is similar in construction to some of the constrained benchmarks. We took that decision 10 years ago because in a maturing market, the bigger companies can have very large weights in unconstrained benchmarks. The JPMorgan DHYI takes only the two largest issues of a company, not all the bond issues. Typically, the two largest ones are the most liquid and investable bonds.

The utilization of a constrained benchmark was not very relevant initially but started to pay off when a number of the larger automakers were downgraded and became very large weights in unconstrained benchmarks. That strategy wasn't very relevant initially, but it started to pay off. We believe that it is appropriate for a credit benchmark to be constrained because we want to avoid concentration. In the end, diversification is much better because of the inherent asymmetry of the market.

Q: What is your view on risk? How do you manage and mitigate it?


A: Putnam has a proprietary risk system that uses trailing spread volatility over the last five years. We apply trailing historical volatilities to the current portfolio to come up with a forward-looking assessment of the market beta. It is a very useful tool, which allows us to see the portfolio beta model every day. We apply quantitative tools at the portfolio, issuer, and sector levels, to make sure that we are being objective about the risk.

As any investor in the high-yield market, we are exposed to credit risk, and we need to know that we are compensated appropriately. That is why we make sure that we measure risk accurately and that we take advantage of our views. How the portfolio comes together as a whole is also important and we make sure that there are no unintended correlations.

As part of our top-down process, we cut the portfolio in many different ways and consider risk on a forward-looking basis. That means looking at bond ratings, yield spreads, yields, and industry over-weights. Ultimately, the goal is to manage the risk more efficiently.

Q: How would you deal with a potential decline in interest rates combined with an economic slowdown?

A: Our investors pay us to be invested in the asset class. Therefore, we remain high-yield investors in all environments, but we shade our view of the market to be defensive or more aggressive. Clearly, as the market looks forward, it is expecting some deceleration in the economy and pressure on certain sectors and companies, but I believe that a big part of the bad news is already reflected.

Only seven months ago, the spread was at 2.65% over Treasuries and today it is at about 7% over Treasuries, and that is a dramatic change. The average spread is about 5.3% over Treasuries, and we have gone through that average and well beyond it. Nevertheless, managing credit risk in a decelerating economy is always a challenge and we believe that the diversification helps. We have the tools and the team that help us to avoid the bigger pitfalls in the market. 

Putnam High Yield Advantage Fund

Symbol	PHYMX
Website	www.putnam.com
Address	Putnam Investment Mgt LLC One Post Office Square 6th Floor Boston, MA 02109
Tel. No.	800-225-1581
Inception	03/25/1986

PORTFOLIO	
Total Net Assets*	\$646.1
Avg Coupon Percent	5.71%
Avg Duration (years)	3.83
Effective Avg Maturity	BB
Turnover Ratio	4.60

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$500
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	\$0.00

RISK (AGAINST JP MORGAN DEVELOPED HIGH YIELD IX - 3 YEARS)	
Alpha	0.66
Beta	0.99
R-Squared	0.93
Ann. Std Deviation	4.60
Sharpe Ratio	0.40

RETURNS VS. JP MORGAN DEVELOPED HIGH YIELD IX		
	PHYMX	Index
1 Year (Cum.)	-2.59%	-2.66%
3 Year (Ann.)	4.79%	4.13%
5 Year (Ann.)	9.83%	9.26%

RETURNS VS. LIPPER HIGH CURRENT YIELD FUND AVG		
	PHYMX	Index
1 Year (Cum.)	-2.59%	-4.03%
3 Year (Ann.)	4.79%	3.02%
5 Year (Ann.)	9.83%	7.96%

FEES AND EXPENSES	
Max Sales Charge - Front**	4.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee***	1.00%
Total Expense Ratio	1.05%

PORTFOLIO MANAGER	
Paul Scanlon	2002
Robert Salvin	2005
Norman Boucher	2005

*millions **a deferred sales charge of 1.00% on class A shares may be imposed on certain redemptions bought without an initial sales charge

*** versus Lipper category average of 1.12%

Data through: 02/29/2008

Source: Company Documents; Lipper

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