

Levine, Robert – How to Make Money with Junk Bonds*McGraw-Hill, 2012, [Finance] Grade* ★★★★★

This is a book on high yield investing that is short on details but long on common sense and real life experience. Robert Levine is the founder, former CEO and CIO of Nomura Corporate Research and Asset Management. Prior he worked with junk bonds for 13 years at Kidder Peabody. During his 18,5 years at NCRAM Levine had an 11,5 percent annual return versus the high yield index with a return of 8,7 percent. The Sharpe ratios were 1,24 and 1,01 respectively. For such a long period this is a huge outperformance.

A key element to Levine's success was that he managed to combine a rigorous credit analysis with a top-down based view on when to be cautious and when to be risk seeking. When the spreads for the high yield universe gets too slim an investor should decrease his weighting to the asset class and at the same time concentrate on high quality BB-rated bonds. My interpretation is that Levine had an ability to not let greed overshadow stringent analysis and hence he avoided credit losses in bad times ("Just say no!"), but even more importantly he performed an analysis of companies' businesses that was more forward looking than most other junk bond investors. Instead of just searching for the highest yield he sought a combination of coupon income and capital gains from positive change in future corporate fundamentals.

What Levine calls his strong horse method is a two-step process where a credit analysis is first performed and then the results are related to the rating and yield of the bond in question. The credit analysis looks to the business risk where Levine search for companies that are market leaders, low cost producers, price leaders with solid management and improving product trends. The company should generate excess cash flow, have controllable debt level and have a history of paying down debt. The risk of debt level must be seen in combination with the riskiness of the business. Further the financial risk is analyzed and Levine's principles are that the higher the EBITDA the

better, that the company should show a positive growth trend in EBITDA, there should be substantial excess EBITDA-coverage of interest expenses (and the trend should be improving), the company should have low Debt/EBITDA and EBITDA minus maintenance capex should be strongly positive. Now, if the fundamentals of the company merits for example a BB-rating either today or more likely in a year of two but the official credit rating is lower than that, the yields don't reflect this discrepancy and there are good covenants attached to the bond then it is a buy candidate. If the rating is correct the bond should be ignored even if it's got a high yield.

The text is well written; it's relatively short, very easy to read and has plenty of real life examples from Levine's career. The book's format makes it possible to get the impression that it is not suitable for institutional investors but only for private investors. This is wrong, since many institutional portfolios would benefit from a better investment process. This is value investing in junk bonds. Levine compares his Strong Horse method to Ben Graham's method of picking stocks: a systematic approach to investing in bonds that have good value. "Looking for companies whose creditworthiness is stronger than their bond rating." Agreed this is very similar to Graham's systematic search for stocks that were worth more than they cost, but given Levine's focus on the growth of high quality companies (for junk bonds that is) I would rather compare his focus area to those of Philip Fisher or Warren Buffett.

On the one hand this is an often sweeping basic introduction to the topic of junk bonds leaving the reader wanting more details on how to perform the business and financial credit analysis, but on the other hand it presents a framework for managing high yield bonds that is both intuitive and that has a proven success. The latter is of course vastly more important. Details of how to perform a credit analysis can be filled in later.

Mats Larsson, November 17, 2012