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There's still juice in junk bonds

High yield debt has achieved major gains - and experts say there's more to come.

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NEW YORK (Fortune) -- Corporations struggled mightily to sell their debt last year, and high yield bonds, which are rated BB and below by S&P, were no exception - prices fell 33% and yields soared to 20 percentage points above those on Treasurys. Now that premium is luring investors, who bought $4.3 billion worth of new junk bonds in January, according to research firm Dealogic.

That's about half of what was sold last January, but nearly twice as much as the previous four months combined. "It's a new year, and people are more willing to take on a little risk," says Michael Anderson, a high yield strategist at Barclays Capital.

As demand for junk bonds rises, prices are climbing: Merrill Lynch's high-yield index rose 12% between December and February. Martin Fridson, owner of Fridson Investment Advisors and a longtime junk bond expert, says it's the highest two-month gain he's seen since 1991. But he also says that high-yield bonds still have plenty of room to climb.

"You might be thinking, gee - if it's gone up that much, I probably missed it," says Fridson. "But at the beginning of the 1990 rally, the price of the junk bond index started at 71. Today, it's just 64."

Despite their recent increase, yields on junk bonds still offer a hefty 15% premium over Treasurys. The historical average is only 5%.

One potential roadblock to a junk-bond recovery would be a decline in Treasury prices; if government bonds begin to offer decent yields, investors are less likely to buy corporates. Yields on 10-year Treasurys have risen 12% since the beginning of the year, and, with massive new issuances planned and a likely decline in foreign buyers, it's possible that they'll continue to rise.

Investors are also wary of widespread defaults. Moody's forecasts that 15% of high-yield debt issuers will fail to pay up this year, compared to a historical average of less than four percent. Bill Walsh, the president of Hennion & Walsh Asset Management, thinks that level of risk negates the shrinking reward that junk bonds offer. "As yields go lower, I don't think there's a lot of value in the junk market," he says.

The current combination of rising defaults and prices is highly unusual; an increase in risk typically induces a decrease in perceived value. But Fridson says the rapid rise in the default rate has less to do with the current economic crisis and more to do with the lack of pressures in recent years.

"During the last phases of the bull market, the financial terms were so favorable for borrowers, there were no financial tests that were likely to trigger defaults," he says. Now, there's far less tolerance for credit risk - and the default rate will rapidly correct itself.

Another reason why yields are plummeting could be that they were simply too high to start with. "The yields were higher than anything we've seen over the course of the last two decades," says Anderson. He thinks that the Moody's estimate is already factored into high-yield debt prices - and that junk bonds will achieve 10% returns this year.

In order to see those benefits, investors should hedge their bets by buying into diversified funds rather than individual bonds. Fridson owns **Vanguard High-Yield Corporate** (VWEHX), which offers a 10.7% yield. Other strong options include **T. Rowe Price's High Yield** (PRHYX), which yields 11.6%, and **Pax World's High Yield** (PAXHX), which yields 13.5% and has already returned a whopping 8.9% this year.

Fridson, like Anderson, thinks that junk bonds will realize solid gains this year - and will produce even bigger returns in 2010. "There are provisos, but it's generally a good time to be looking at high yield funds," he says.