

Treasure hunt

Investors can make a fortune out of the financial crisis, writes *Eddy Wong*

The financial crisis has continued to shake global markets. Huge write-downs have contracted the balance sheets of financial heavyweights in the U.S. and Europe, and the global economy looks certain to slip into recession. Although U.S. President George W. Bush signed into law the US\$700 billion bailout package, the market reacted negatively, with the Dow Jones Index closing below 10,000 points on 6 October, the first time in four years.

As more negative news is expected in the months to come, most investors are staying on the sidelines and

waiting for signs of recovery. Even the most experienced economists or analysts are unable to tell if the market has hit the bottom.

Long-term investors, however, need not despair. The golden rule is to invest when valuations are cheap. According to a *EuroFinance* survey, 80 percent of business professionals feel there is a buying opportunity in the current financial crisis.

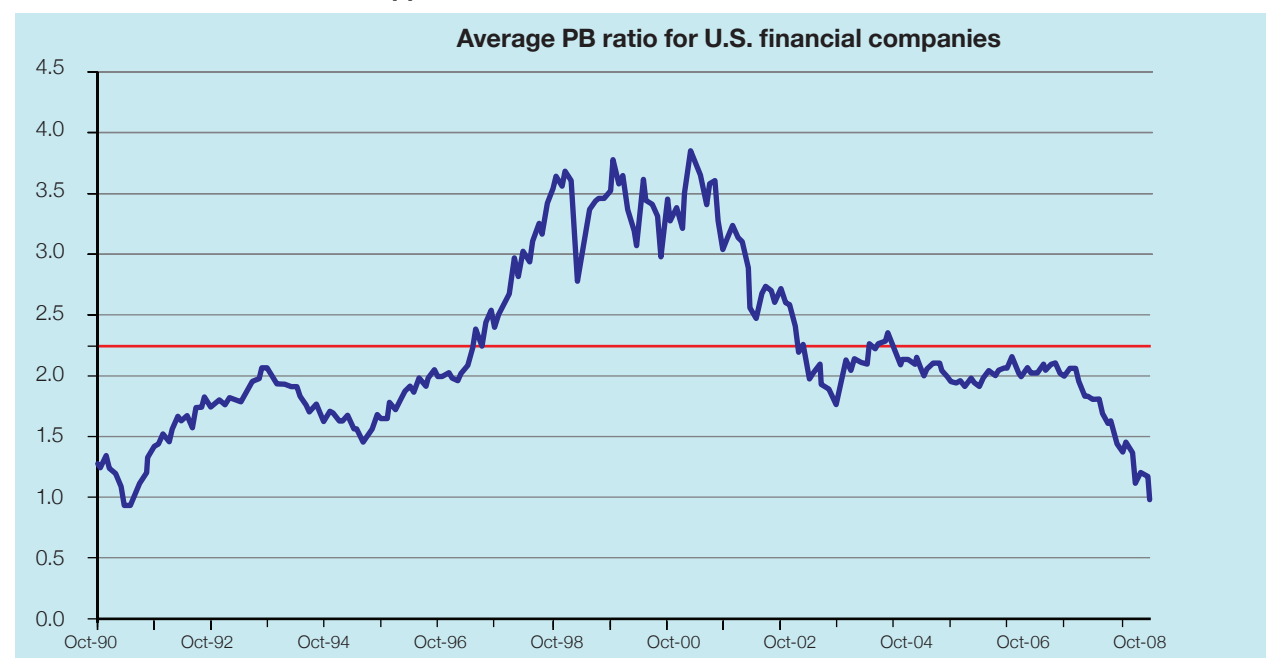
Financial sector funds and U.S. high yield bond funds have emerged as very attractive investments after a panic sell-off of financial stocks by investors in recent weeks sank share prices, which

dragged down their price-to-book ratio.

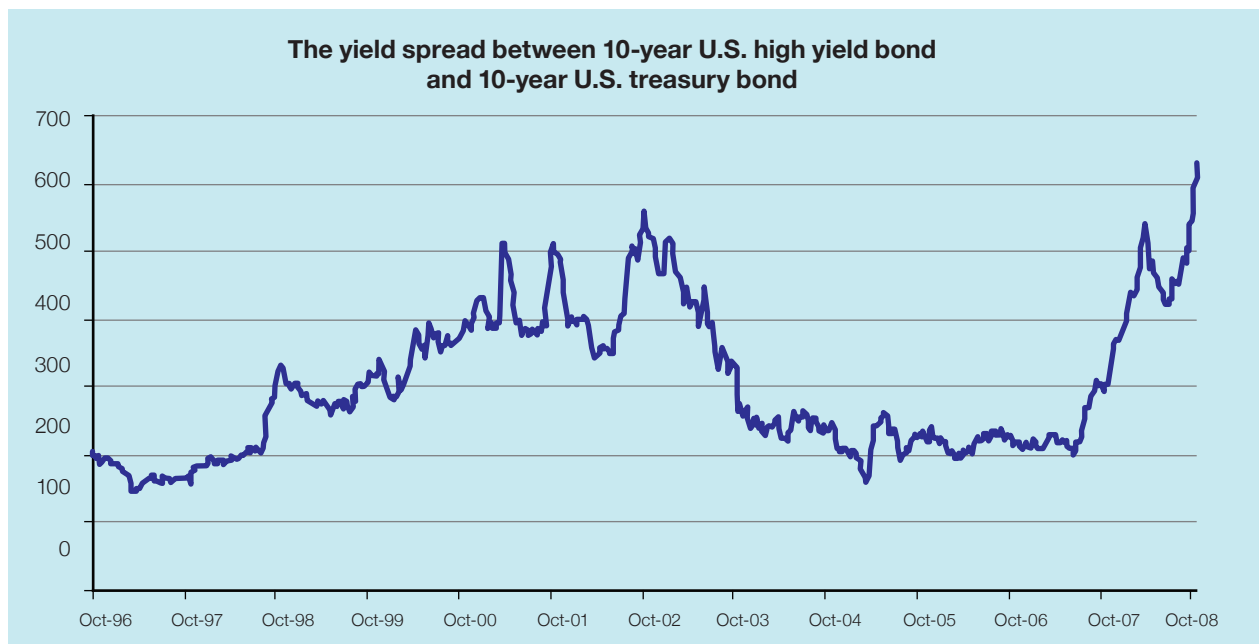
When earnings are negative, PB ratio works better than price earnings ratio in helping analysts evaluate financial and property stocks.

A PB ratio of 1.0X means the share price equals the total worth of a company if it sells all its assets. Take banks as an example. In their business models, most banks' assets are loans made to borrowers. Because loans are rarely valued above their historical costs, the PB ratio of banks would be a better valuation measure than their PE ratio, which would have been adversely affected by the massive write-downs.

Chart 1: Price-to-book ratio dropped below 1.0X (as of 15 October 2008)



Source: Bloomberg and IFAST compilation

Chart 2: Yield spread widens

Sources: Bloomberg and iFAST compilation

The current PB ratio of U.S. financials (see chart 1) has nearly dropped to its 1990s level, when the U.S. economy fell into a recession following the savings and loans crisis. The ratio, standing at about 0.98X as of 15 October 2008, is much lower than the 18-year average of about 2.2X.

Investors should note that more write-downs will lead to a drop in the book value and an increase in the PB ratio. The total write-downs by financial institutions across the world amounted to US\$646.4 billion as of 15 October 2008. Although the write-downs may increase in the coming months, we believe the value of write-downs has reached its peak (US\$168.1 billion) in the first quarter this year.

High yield bonds

High yield bonds refer to non-investment

grade bonds, also known as speculative grade and junk bonds, and we will focus on corporate bonds here.

High yield bonds are usually rated BB or below by credit rating agencies, which assign ratings based on issuers' financial strength and credit fundamentals.

The spreads between U.S. high yield bonds and U.S. treasury bonds is the proxy that we use to determine how attractive high yield bonds are. If the spread is narrow, the corporate debt default rate is low.

Chart 2 shows the yield spread widened to a historic high on 15 October 2008, approaching its level in 2002. At the time, global non-investment grade bonds had a default rate of 21.28 percent. Moody's, however, forecast that the default rate by the end of the year will stand at around 5.7 percent only – still much

lower than its 2002 level.

U.S. high yield bonds are attractive both because of their potential capital gains when the spread narrows and their higher coupon rate. For example, a U.S. high yield bond fund can distribute cash dividend of an annualized monthly yield ranging from 5 percent to 9 percent between 2003 and October 2008.

In fact, the cash dividend paid per unit of these funds is relatively stable and can provide regular and stable income for investors.

The ultimate goal for all investors is to buy low and sell high. Investing during a crisis can benefit long-term investors with an investment horizon of three to five years.

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