

A guide to investing in high-yield bonds

What you should know before you buy

Are high-yield bonds suitable for you?

High-yield bonds are designed for investors who:

- Can accept additional risks of investing in high-yield bonds in exchange for potentially higher rates of interest
- Want to diversify their assets across different segments of the financial market
- Value the flexibility to choose a specific sector or company to invest in
- Have access to information or professional guidance to help them select and monitor specific issues

Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs and liquidity objectives with your Financial Advisor. This guide will help you better understand the features and costs associated with high-yield bonds, as well as how your Financial Advisor and Wells Fargo Advisors are compensated when you invest in these products.

The basics of the high-yield bond market

Bonds are debt securities issued by organizations to raise capital for various purposes. When you buy a bond, you lend your money to the entity that issues it. In return for the loan of your funds, the issuer agrees to pay you interest and ultimately to return the face value (principal) when the bond reaches **maturity**,¹ or is **called**, at a specified date in the future known as the “maturity date” or “call date,” respectively.

¹*Terms in bold are defined in the glossary at the end of the guide.*

What are high-yield bonds?

High-yield bonds are issued by organizations that do not qualify for **investment-grade** ratings by one of the leading credit rating services, such as Moody’s Investor Service, Standard & Poor’s and Fitch Ratings. These rating services evaluate issuers and assign ratings based on their judgment of the issuer’s ability to pay interest and principal as scheduled. Those issuers with a greater risk of **default** are rated below investment-grade. These issuers must pay a higher interest rate to compensate investors for the increased risks associated with investing in organizations of a lower credit quality. High-yield bonds can be issued by many different types of U.S. corporations, certain U.S. banks, various foreign governments and a few foreign corporations.

How do credit ratings affect yield?

Rating services use quantitative tools and qualitative judgments to evaluate the creditworthiness of an issuer and have developed a grading system from which they assign **credit ratings** to these issuers. Typically, only bonds issued by the largest and strongest companies qualify for investment-grade ratings, which indicate strong relative credit. The highest quality rating is triple-A. The rating levels descend to triple-C as the possibility of default increases and finally to D, or “default.”

Bonds considered to carry minimal likelihood of default are investment grade and are rated Baa3 or higher, according to Moody’s ratings system or BBB- or higher, according to the rating systems used by Standard & Poor’s and Fitch. The bonds issued by

companies rated below Baa3 or below BBB- are considered “speculative.” They have a higher risk of default and are classified as high-yield bonds, commonly known as **junk bonds**. Additionally some types of nonrated bonds may also be considered high yield bonds. The table below defines the ratings assigned by the three services and describes the credit risks associated with investment-grade and speculative (below-investment-grade) debt.

Rating assignment — Credit risk	Rating services		
	Moody's*	S&P†	Fitch†
Investment			
Highest possible credit rating - Principal and interest considered very secure	Aaa	AAA	AAA
High quality - Differs from highest rating onlin in degree of protection offered to bondholders.	Aa	AA	AA
Good ability to pay interest and principal - More adverse effects due to changing conditions	A	A	A
Adequate ability to make principal and interest payments - Adverse conditions are more likely to affect ability to service debt	Baa	BBB	BBB
Below investment-grade (speculative)			
Issuer faces ongoing uncertainties or exposure to adverse business or economic conditions	Ba	BB	BB
Greater vulnerability to default, but currently meeting debt service requirements	B	B	B
Current identifiable risks of default; in some cases, bonds already in default	Caa	CCC	CCC
Most Speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
Bonds in default	D	D	D

* The ratings from Aa to Ca may be modified by the addition of a 1, 2 or 3 to show standing within the category.
† The ratings from AA to CC by Standard & Poor's and Fitch Ratings may be modified by the addition of a plus or a minus sign to show relative standing within the category.

To compensate investors for the additional risks, issuers with lower credit ratings generally must pay a higher rate of interest than companies whose bonds are given an investment-grade rating. This compensation may, in turn, generate a higher yield for investors.

However, you should not purchase high-yield bonds based on potential yield alone; you should also consider the credit risk or risk of default associated with the issuer, and how that risk might affect the safety of your investment.

Structures of high-yield bonds

As the high-yield market has grown, companies have become more creative with the structure of bond issues. The following varieties of issues may be found in today's market:

Cash-pay bonds – The high-yield market's “plain vanilla” bonds, they offer investors a fixed-coupon rate of interest, paid in cash, until maturity or an earlier stated redemption date.

Step-coupon bonds – Offer one interest (coupon) rate in the early years of the bond's life, followed by a second, higher interest rate at a specified time (the step-up date) in later years. Most of these bonds are callable at a premium on the step-up date.

Payment-in-kind bonds – Allow the issuer the option of paying the bondholder interest either in additional securities or in cash. This structure is not common in the marketplace.

Zero-coupon bonds (“zeros”) – Sold at a deep discount from their face value and pay no current interest to the bondholders. Instead, the interest is compounded and is paid with the principal at maturity. (See “Tax Treatment” for more information on zero-coupon bonds.)

Convertible bonds – May be converted into shares of another security under stated terms. The security is often the issuing company’s common stock.

Who issues high-yield bonds?

The high-yield bond market has existed since the 1970s and has grown dramatically in the past 30 years. In the 1980s, high-yield bonds were often used to finance speculative takeovers or mergers. Today, the market has broadened to include many dealers and issuers with diverse needs. Issuers of high-yield bonds can be grouped into the following categories:

- Emerging or start-up companies that have not yet achieved the operational history, size or capital strength required to attain an investment-grade rating. These companies may turn to the bond market to obtain seed capital.
- Former investment-grade companies experiencing hard times that cause their credit to drop from investment-grade to lower ratings.
- High-debt companies (which may have “blue chip” status in terms of their size and revenues; in other words, they are nationally recognized as being well-established and financially sound companies). They are generally leveraged with above-average debt loads that may cause concern among rating services. Companies refinancing debt sometimes turn to high-yield bonds to pay down bank lines of credit, retire older bonds or consolidate credit at attractive rates of interest. Companies also turn to the high-yield bond market for capital to fund acquisitions or buyouts, or to fend off hostile takeovers.
- Leveraged buyouts (LBOs) create a special type of company that typically uses high-yield bonds to buy a public corporation from its shareholders, often for the benefit of a private investment group that may include senior managers.
- Capital-intensive companies in industries that require a large amount of money and other financial resources (capital) to produce their goods (like the automobile and oil industries) may turn to the high-yield market when they are not able to finance all their capital needs through earnings or bank loans.
- Foreign governments and foreign corporations may rely on high-yield bonds to attract capital. Please note that there are other risks — such as those associated with currency price changes and political changes or instability in a country — that are unique to bonds issued by a foreign government/corporation.

Who buys high-yield bonds?

A variety of investors participate in the high-yield bond market. They include individuals who invest in high-yield bonds through direct ownership and/or through mutual funds, insurance companies, pension funds and other institutions.

Individual investors – Individuals purchase high-yield bonds, either directly or through high-yield mutual funds.

High-yield mutual funds – Equity and bond mutual funds may purchase high-yield bonds in an attempt to enhance the performance of an aggressive portfolio.

Hedge funds¹ – Some hedge funds also purchase high-yield bonds in an attempt to enhance the performance of an aggressive portfolio.

Insurance companies – Insurance companies often purchase high-yield bonds for their own investment needs or to fund the “separate accounts” of variable insurance and annuity products.

Pension funds – Trustees of pension funds are fiduciaries that must invest within “prudent man” guidelines and other considerations, which vary from state to state. Recently, in some cases, these guidelines have been relaxed, allowing pension funds access to the high-yield marketplace.

Features and characteristics

High-yield bonds can offer investors the following features:

Potentially higher income – High-yield bonds offer potentially higher income than more conservative fixed-income investments. The **yield spread** between high-yield bonds and investment-grade bonds has typically been between two and four percentage points, depending on the issuer and market conditions. However, current market conditions and high volatility have caused spreads to expand dramatically outside this typical range. These higher yields come with an increased risk of default. Consequently, investors should be cautious; high-yield bonds should comprise only a portion of their entire portfolios.

Capital-appreciation potential – Positive events in the economy, industry or issuing company can potentially reward you with increases in high-yield bond prices, otherwise known as “capital appreciation.” These events include ratings upgrades, improved earnings reports, mergers or acquisitions, positive product developments or market-related events.

¹*Hedge funds are complex investment vehicles and are not suitable for all investors.*

Priority of claims	
First claim	Secured debt holders
	Unsecured senior debt holders
	Other unsecured, subordinated debt holders
Subsequent claims	Preferred stockholders
	Common stockholders

Seniority/priority of claims – Bondholders usually have priority over stockholders in a company’s capital structure and are more likely to receive payment in the event the company goes bankrupt. The percentage of this payment compared with the original investment is called the “recovery rate.” As the accompanying table shows, the holders of “secured debt” and “unsecured senior debt” have the highest claims on corporate assets in a bankruptcy distribution. Even the holder of a low-rated bond is entitled to a share of a failing company’s assets before preferred or common stockholders.

Portfolio risk diversification – High-yield bonds are often considered a separate asset class, involving different characteristics from those of other securities. High-yield bonds can help you spread assets across different segments of the financial market, potentially reducing your portfolio’s concentration in any one asset class.

Flexibility – You can choose a specific sector or company you prefer to invest in, depending on your individual investment objectives and risk tolerance.

Exchange listing – Some bonds are listed on the New York Stock Exchange or the American Stock Exchange. Some investors prefer listed bonds for added liquidity and for the ability to track the bonds’ daily trading movements.

Risks

Before investing in high-yield bonds, you should understand the risks associated with them. As with any investment, your Financial Advisor can advise you on whether high-yield bonds fit into your overall investment objectives.

Credit risk – The potential for loss resulting from an actual or perceived deterioration in the financial health of the issuing company. Two subcategories of credit risk are “default risk” and “downgrade risk”:

- **Default risk** – Defaults occur when a company fails to pay an interest or principal payment to a debt holder as scheduled and as specified in the legal agreements, i.e., the indenture. The risk of default on principal or interest, or both, is greater for high-yield bonds than for investment-grade bonds. Factors such as business cycle volatility, excessive leverage or threats of competitive takeovers may lead to default. In a corporate bankruptcy or dissolution, although secured bondholders and holders of senior debt issues may receive some distribution of corporate assets, it is rarely enough to “make whole” their total investment. Bonds of companies in default tend to trade at very low prices, if they trade at all, and liquidity may be nonexistent.

- **Downgrade risk** – Downgrades result when rating agencies lower their rating on a bond. A company’s rating, for example, could be downgraded from BBB to BB if the rating agency believes the issuer has become less able to meet its debt obligations. Downgrades are usually accompanied by bond price declines. In some cases, the market anticipates downgrades by bidding down prices prior to the actual rating-agency announcement. Before bonds are downgraded, agencies often place them on a “credit watch” list (which means that the issue is being reviewed for possible re-rating), which also tends to cause price declines. (See the “Managing Risk” section for more information on credit-watch status.)

Market risk affects all investments. When interest rates are moving higher, bond prices will normally fall; when rates are moving lower, bond prices will normally rise. The longer term the bond, the more prices fluctuate with movements in interest rates.

Interest rate risk – Changes in interest rates affect fixed-income security prices. There is an inverse relationship between bond prices and interest rates. In other words, as interest rates rise, bond prices fall; as interest rates fall, bond prices rise. The longer the maturity of the bond, the more it will fluctuate in relation to interest rates.

Call risk – Most high-yield bonds are callable after five years following the issue date at par (par is generally \$1,000) or above. Some bonds are non-callable for the life of the bond. After the non-call period, the issuer has the right (but not the obligation) to call the bond for any reason before its stated maturity. As a practical matter, an issuer will generally decide to call a bond when it can issue a new bond at a lower rate than the existing bond. Investors considering an investment in high-yield bonds should note that under this scenario it is unlikely that they would be able to replace their called bond with one that pays an equivalent interest rate.

Liquidity risk – Liquidity refers to the investor’s ability to sell a bond quickly and at an efficient price, as reflected in the bid-ask spread. A difference may exist between the prices that buyers are bidding and the prices that sellers are asking on large, actively traded bond issues. The gap (the bid-ask spread) is often small, producing greater liquidity. As the spread rises on less-actively traded bonds, so does the liquidity risk. With a high-yield bond, some issues may have decreased liquidity because fewer dealers are willing to buy or sell a particular issue at any given time. Usually, the smaller the issuer or the lower the rating, the less liquidity will be available to investors who wish to sell a security.

Economic risk – This describes the vulnerability of a bond to downturns in the economy. For example, in 1990, when the U.S. Gross Domestic Product went into a decline that lasted three consecutive quarters (a **recession**, as defined by the Bureau of Economic Analysis of the U.S. Department of Commerce), the principal value and the **total return** of high-yield bonds declined significantly. Virtually all types of high-yield bonds are vulnerable to economic risk. During economic downturns, high-yield bonds typically lose more principal value than investment-grade bonds, as investors get nervous and begin a “flight to quality” – selling lower-rated bonds or equities to buy much higher-rated debt like U.S. Treasury bonds or investment-grade corporate bonds.

Event risk – Encompasses a variety of pitfalls that can affect a company’s ability to repay its debt obligations on time. These include poor management, changes in management, failure to anticipate shifts in the company’s markets, rising costs of raw materials, regulations and new competition.

Ongoing monitoring of the publications of the rating agencies may indicate advance warnings of market difficulties. Additionally, you should follow the industry as well as the issuer closely—just as you would follow equities—to help anticipate factors that may impact the credit rating or the price of a bond.

Managing risk

Depending on your risk tolerance, there may be a place in your investment strategy for high-yield bonds – but they are not suitable for all investors. In addition to a tolerance for risk, investors in high-yield bonds must also have the patience to weather periodic market downturns or unexpected events that negatively impact individual issues. You also need access to information or professional guidance in selecting and monitoring specific issues. Some techniques for helping reduce some of the special risks of the high-yield bond market include the following:

Diversify across issuers and industry segments – You should not put all your assets in one high-yield bond or asset class. Spreading money among several issuers and industries can help reduce the risk of price declines or defaults caused by industry-specific situations/circumstances.

Adjust portfolios over economic and market cycles – For example, seek to sell bonds from an industry facing an economic downturn and purchase bonds in an industry with a more positive outlook.

Monitor credit ratings and research – You should follow the publications of the rating services to determine whether a bond has been downgraded or is on a “credit watch” list. In addition, you should monitor the research and credit analysis of an individual issuer.

Follow company and industry news – You should watch an industry or an issuer closely – just as you would monitor stocks – to help anticipate factors that may affect the credit rating or the price of a bond.

Tax treatment

As corporate debt instruments, high-yield bonds are subject to the same tax treatment for individuals as investment-grade corporate bonds, as described below. Keep in mind that Wells Fargo Advisors is not a tax or legal advisor. For advice about your specific situation, consult your personal tax advisor.

Interest – The interest you receive from corporate bonds is subject to both federal and state income tax. This interest is taxed as “ordinary income,” like wages.

Gains and losses – Selling your high-yield bond in the secondary market prior to maturity may generate capital gains or capital losses. Depending on the amount of time you held the high-yield bond prior to liquidating will determine how any gains will be taxed. Capital losses may offset dollar-for-dollar capital gains you have realized on other investments (bonds, stocks, mutual funds, real estate, etc.). Please note that Wells Fargo Advisors, its affiliates and Financial Advisors may not offer tax, legal or accounting advice. Due to the potential complexities of the tax treatment of and tax reporting requirements for high-yield bonds, you should consult with your tax or legal advisor prior to investing in any high-yield bond.

Zero-coupon bonds – Zero-coupon bonds are relatively rare in the high-yield market, although there are many zero/step-coupon bonds (bonds whose interest rates are “stepped up” over time). As described previously, zero-coupon bonds pay no current interest; instead, they pay all accrued interest at maturity. Zero-coupon bonds are issued at prices well below their par (maturity) values. A similar type of bond, known as an “original issue discount (OID)” bond, is issued below par value and may pay out some interest. The federal tax treatment of zero-coupon and OID bonds is quite complicated; if you plan to invest in them, first consult your tax advisor. While you own these bonds, you must pay tax each year on a portion of the discount, even if you do not receive any current interest income.

Tax-exempt high-yield bonds – When lower-rated governments, municipalities and municipal agencies issue bonds, these are considered high-yield municipal bonds. The interest on these bonds may be exempt from federal income tax and from state and local income tax for residents of the state of issue. Consult your tax advisor for more information on tax-exempt high-yield bonds.

Costs of investing in high-yield bonds

High-yield bonds are bought and sold between dealers and investors much like other debt instruments. Dealers trade the securities at a net cost, which includes their own spread, or profit, on the transaction. Upon purchase and sale of a high-yield bond, you will incur a commission or mark-up as a cost of processing each transaction. The commission or mark-up covers all costs incurred, including administration, transaction and a sales concession paid to your Financial Advisor.

Investor characteristics

Because of the volatile nature of high-yield bonds, individual investors should carefully consider the suitability of high-yield bonds as an investment vehicle before investing.

Suitability – High-yield bonds are not suitable for all investors. You should evaluate your individual financial condition and your ability to tolerate risk before you invest in high-yield bonds. Wells Fargo Advisors does not generally recommend the purchase of single high-yield issues for clients with a conservative risk tolerance. As an alternative, conservative investors may consider the purchase of a high-yield bond mutual fund if suitable based on your specific goals and investment objectives. You should not purchase high-yield bonds based on yield alone but also consider the credit risk or risk of default associated with the issuer and how that risk might affect the safety of your investment.

Diversification – It is recommended that investors observe an asset allocation strategy and not overweight their overall portfolio in any one class of securities, especially high-yield bonds. Although asset allocation can be an effective investment strategy, it cannot eliminate the risk of fluctuating prices and uncertain returns.

How your Financial Advisor and Wells Fargo Advisors are compensated on high-yield bonds

For helping you invest in the most appropriate high-yield bonds, Wells Fargo Advisors and your Financial Advisor are compensated in ways that vary depending on the selected investment. Your Financial Advisor may receive compensation in the form of a commission or mark-up from most transactions.

For most purchases, a Financial Advisor's compensation is based on the dollar amount purchased or sold. In certain fee-based accounts, a Financial Advisor's compensation is based on a percentage of total assets in the account rather than on the concession as mentioned above. The compensation formula that determines the amount of payment to your Financial Advisor in certain fee-based accounts is generally the same for all high-yield bonds.

Within the division that operates in Wachovia² financial centers and some Wells Fargo stores a Licensed Banker may refer you to a Financial Advisor, as they generally work as a team. In this case, the Licensed Banker will be compensated through a referral arrangement with the Financial Advisor. Wells Fargo Securities, LLC may receive compensation for making a market or keeping an inventory on select bond offerings. Wells Fargo Securities may have an investment banking relationship with bond issuers. Disclosures of any such conflicts are noted on research reports.

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Talk to your Financial Advisor

Determining whether high-yield bonds are an appropriate investment strategy for you requires an in-depth evaluation of your individual financial situation and the objectives you want to achieve. Talk to your Financial Advisor today about how high-yield bonds may help you work toward your investment goals.

² Effective March 20, 2010, Wachovia Bank, N.A. will become Wachovia Bank, a division of Wells Fargo Bank, N.A.

Additional information

To learn more about high-yield bonds, ask your Financial Advisor or visit the following Web sites:

Wells Fargo Advisors

wellsfargoadvisors.com

Financial Industry Regulatory Authority (FINRA)

finra.org

U.S. Securities and Exchange Commission

sec.gov

Trace Report Reference

investinginbonds.com

Securities Industry and Financial Markets Association (SIFMA)

sifma.org

Glossary

Call – A decision of the bond issuer to repurchase the bond from the holder at a specified date and price. Most high-yield bonds are callable after five years following the issue date at a premium to par (par is generally \$1,000). Some bonds are noncallable.

Credit rating – The evaluation of a bond issuer's creditworthiness and credit standing, as determined by a credit rating service such as Standard & Poor's, based on quantitative tools and qualitative judgments.

Current yield – The annual interest payment (coupon rate) of a bond, divided by the current price of the bond.

Default – The failure of a bond issuer to pay interest or principal when due.

Investment-grade – Bonds considered to have a relatively low rate of risk (rated AAA to BBB).

Junk bonds – A term used to refer to the below-investment-grade status of high-yield bonds.

Liquidity – The ability to buy and sell bonds in an orderly and timely fashion.

Maturity – The date when the bondholder will receive the final interest payment and the repayment of principal. The face value of most bonds is \$1,000.

Total return – A measure of bond investment return that includes both interest and price change. The total return on investments is generally expressed as an annualized rate, and assumes reinvestment of all interest back into the investment.

Yield to maturity (YTM) – A calculation of the total return to a bond investor who holds to maturity. YTM includes interest payments and any difference between the current price and maturity (par) value. It does not include return of principal at maturity. YTM is calculated based on the current market price.

Yield spread – The difference in yield between two bonds or bond indexes.

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