The Truth about Junk Bonds

By Sean Beckett

Junk bonds have been a common element in some of the country’s worst financial wrecks this year. The Campeau retailing conglomerate collapsed in January under a heavy debt burden, much of it junk bonds. First Executive Corporation, one of the nation’s largest insurance companies, announced a fourth-quarter 1989 loss of $859 million on its junk bond holdings. And Drexel, Burnham, Lambert, the investment bank responsible for the growth of the junk bond market, filed for bankruptcy in February 1990.

These corporate casualties are only the most recent of the problems blamed on junk bonds. For years, some critics have claimed junk bonds are responsible for a host of broader financial market ills. According to these critics, junk bonds fueled the merger mania of the 1980s, caused the rapid growth in the level of corporate debt in recent years, and more generally increased financial market volatility.

If these serious charges are accurate, it may be time for laws or regulations to restrict the use of junk bonds. But if the charges are not accurate, restricting the use of junk bonds would unnecessarily increase the cost of funds for many businesses.

The truth is that the evidence does not support these extreme charges against junk bonds. To be sure, there may be other concerns about junk bonds, such as whether junk bonds are suitable investments for banks and thrifts. This article does not address concerns such as these. Instead, the article examines whether junk bonds should be blamed for the rise in corporate mergers, corporate debt, and financial market volatility. The first section of the article defines junk bonds. The second section explains why some critics make these accusations against junk bonds, and the third section shows why these charges are not well-founded.

I. What Are Junk Bonds?

A corporation can obtain funds in many ways. It can raise funds by retaining earnings, issuing equity, or floating debt. If it chooses to take on debt, the corporation faces further choices. For short-term finance, it can issue commercial paper or take out bank loans. For intermediate and long-term finance, it can take out
bank loans, mortgage property, privately placed bonds, or issue marketable corporate bonds. If the corporation chooses to issue marketable bonds, the bonds might be junk bonds.

Junk bonds are corporate bonds with low ratings from a major ratings service. Bond ratings are letter grades that indicate the rating services' opinions of the likelihood of a default. High-rated bonds are called investment-grade bonds, low-rated bonds are called speculative-grade bonds or, less formally, junk bonds.

A bond may receive a low rating for a number of reasons. If the financial condition or business outlook of the company is poor, bonds are rated speculative-grade. Bonds also are rated speculative-grade if the issuing company already has large amounts of debt outstanding. Some bonds are rated speculative-grade because they are subordinated to other debt—that is, their legal claim on the firm's assets in the event of default stands behind the other claims, so-called senior debt.

Junk bonds are traded in a dealer market rather than being listed on an exchange. A small group of investment banks makes a market in these securities; that is, they stand ready to buy or sell junk bonds. Participating investment banks typically make a market in the issues they underwrite and in a limited number of relatively heavily traded issues considered "good credits."

Institutional investors hold the largest share of junk bonds. At the end of 1988, insurance companies, money managers, mutual funds, and pension funds held three-quarters of the face value of the outstanding junk bonds (SEC 1990, p. 22). Individual investors held only 5 percent of the outstanding bonds.

II. Why Are Junk Bonds Criticized?

Junk bonds have been blamed for three financial market ills in recent years: the merger boom, the rise in corporate debt, and the increase in financial market volatility. Critics connect junk bonds with these developments because they occurred simultaneously during the 1980s.

The market for junk bonds was revitalized in the late 1970s and the 1980s after decades of inactivity. In 1977, the investment banking firm of Drexel, Burnham, Lambert began underwriting original-issue junk bonds. From 1977 through 1981, new issues never exceeded $1.5 billion (Chart 1). Then, starting in 1982, junk bond issues enjoyed five years of explosive growth. New issues peaked in 1986 and receded slightly in the last few years to between $25 billion and $30 billion a year. The face value of outstanding junk bonds is currently in the neighborhood of $200 billion, up almost twenty-fold over ten years ago.

As the junk bond market flourished during the last decade, mergers, corporate debt, and financial market volatility also grew. From the end of 1979 through the end of 1989, the value of U.S. mergers grew more than 300 percent. Corporate debt grew over 270 percent. Volatility in U.S. bond markets reached an all-time high in the 1980s. In addition, notable episodes of financial market volatility were the stock market collapses of October 1987 and October 1989.

More than mere coincidence, however, is needed to blame the financial market ills of the 1980s on the growth of the junk bond market. The decade of the 1980s saw the rise of many financial market innovations besides junk bonds—financial futures, program trading, portfolio insurance, and asset-backed securities to name just a few. Why single out junk bonds as the cause of the merger boom, the growth in corporate debt, and financial market volatility?

Some observers suggest that junk bonds caused both the merger boom and the growth in corporate debt by extending credit too freely. According to this argument, corporations unable to borrow in traditional debt markets obtained funds by issuing junk bonds. Some potential acquirers found it easy to float junk bonds to raise...
Chart 1
New Issues of Junk Bonds

*Annualized estimate from data for the first nine months of 1989.

...the funds for their corporate takeovers. Similarly, some corporate borrowers took advantage of lower credit standards in the junk bond market to go on a debt "binge." 

Observers also suggest that the unusual volatility and unpredictability of junk bonds led to higher financial market volatility. This argument is related to the previous one. If, as some critics believe, junk bonds are the result of declining credit standards, then the market for junk bonds is prone to collapse. Investors may initially enjoy high returns, but the borrowers' failure to generate enough earnings to redeem the bonds leads inevitably to defaults. The prospect of these defaults causes frequent shifts in investor portfolios, from junk bonds to safer assets and back again, as investor confidence in junk bonds ebbs and flows with every change in the financial news. These shifts into and out of junk bonds increase the volatility of returns in other markets, such as the market for investment-grade corporate bonds and the market for equities.8

These arguments about the links between junk bonds and other financial market developments imply that junk bonds are qualitatively different from other securities and forms of debt. No one claims that such conventional securities as investment-grade bonds or equity extend funds too freely. Nor are these conventional forms of finance accused of causing excessive financial market volatility. Thus, if junk bonds are responsible for the growth in corporate debt, the merger boom, and the increase in financial market...
volatility, they must have some special characteristic that sets their behavior very much apart from that of other forms of finance.

III. The Truth about Junk Bonds

This section disputes the idea that junk bonds have special characteristics—the key assumption behind the charges against junk bonds. The section then discusses specific flaws in each of the claims and draws the following conclusions: First, junk bonds played a relatively small role in financing the merger boom of the 1980s. Second, junk bonds are too small a part of the debt market to account for the growth in corporate debt. Third, the timing of the growth in junk bond issues is not closely related to financial market volatility.

Junk bonds are similar to conventional investments

Junk bonds are similar to other, familiar investments with respect to the four principal characteristics of investments: risk, return, liquidity, and control over corporate management. When measuring investments along each of these four dimensions, junk bonds lie between such conventional investments as equities, investment-grade bonds, bank loans, and private placements.

Junk bonds are riskier than investment-grade bonds but less risky than equities. Altman (1988) finds that the junk bond default rate, a key component of risk, was 2.2 percent for the years 1970 through 1986, compared with just 0.2 percent for all publicly issued corporate bonds. A more comprehensive measure of risk is the standard deviation of returns. Perry and Taggart (1990) find the standard deviation of monthly returns of junk bonds is greater than that of investment-grade bonds but less than that of equities and of the capital market as a whole.

Junk bond returns lie between those of investment-grade bonds and equities. Blume and Keim (1990) find that from January 1977 through December 1988 average monthly junk bond returns were 0.89 percent, higher than the 0.71 percent earned by investment-grade bonds and lower than the 1.14 percent earned by stocks. Perry and Taggart examined the relative performance of various portfolios in the quarters just preceding, during, and just after the seven post-World War II recessions. They found, again, that junk bond returns were intermediate between those of investment-grade bonds and equities.

Junk bonds are more liquid than bank loans and private placements but less liquid than equities. Loan contracts and private placements typically contain customized clauses protecting the rights of the investors and restricting the actions of the borrowers. These clauses reduce the marketability of loans and private placements by increasing the cost to third parties of analyzing and valuing the debts and by increasing the frequency of renegotiation. Junk bonds, in contrast, are relatively standardized securities with an established secondary market. Even issues in default have a limited secondary market allowing investors to cut their losses and avoid protracted bankruptcy proceedings. Recent disruptions in the junk bond market, however, are a reminder that the junk bond secondary market is neither as developed nor as liquid as the secondary market for equities.

Junk bonds offer investors more control over corporate management than investment-grade bonds but less control than bank loans, private placements, and equities. Some junk bonds contain "equity kickers," that is, options or conversion privileges that let investors obtain an equity share in the borrowing firm. These features give investors the option to participate in the management of the firm. In addition, some junk bonds are sold in strip financing deals, where both bonds and stocks are sold in fixed proportions to investors. In this case, bond holders have voting rights in the management of the firm.
Since junk bonds are not markedly different from other securities, it is hard to understand why they should have any special ability to trigger corporate borrowing sprees. Junk bonds may have cost or tax advantages that allow for some marginal increase in debt. But these advantages are not likely to induce bondholders to invest in junk bonds more recklessly than they do in other debt instruments that are not materially different from junk bonds. Indeed, the bulk of junk bonds are purchased by the same institutional investors who purchase the bulk of private placements, investors who presumably apply the same credit standards to both types of investment.

Again, because junk bonds are similar to traditional financial instruments, it is doubtful they have any special ability to disrupt financial markets. As in any new financial market, the junk bond market may endure brief periods of somewhat greater volatility than average as the market matures and as investors learn how to analyze the investment characteristics of junk bonds. This extra volatility in the junk bond market may be transmitted to other markets as investors adjust their holdings of junk bonds and other securities. However, the fundamental investment characteristics of junk bonds are similar to those of other well-understood securities, such as equities and investment-grade bonds. All of these markets endure episodes of turbulence: the junk bond market does not stand alone in this regard.

In sum, the similarity of junk bonds to conventional financial instruments casts doubt on claims that junk bonds are responsible for the financial market ills of the 1980s. Furthermore, there are specific reasons why junk bonds should not be blamed for these events.

**Junk bonds and the merger boom of the 1980s**

The junk bond market is too small to have caused the 1980s merger boom. Although a large fraction of the junk bonds issued in the late 1980s were used to finance corporate takeovers, junk bonds accounted for only a small share of merger finance. Even if all junk bonds issued had been used to finance mergers, junk bonds would have accounted for less than 8 percent of the value of U.S. mergers each year. Because not all junk bonds are used to finance mergers, this ratio is a generous upper bound on the junk bond share of merger finance. Moreover, a General Accounting Office study (1988) found that the bulk of the initial financing for tender offers came not from junk bonds but from bank loans. Thus, junk bonds appear to have played a minor role in financing mergers in the 1980s.

Some critics argue that junk bonds were the catalyst for many mergers and, in this way, caused the merger boom despite their small share in merger finance. It is true that junk bonds played a prominent role in several well-publicized mergers, and it is likely that the availability of junk bonds made a few more mergers possible than would have been the case without junk bonds. However, there are many ways to finance a merger. If junk bonds had not been available, mergers that made economic sense would probably have found other forms of finance. Indeed, previous merger booms have occurred without the aid of junk bonds. For example, during the merger wave of the late 1960s—the most recent merger wave prior to the current one and by some measures as significant as the wave of the 1980s—there was no market for original-issue junk bonds. This lack of junk bond financing in no way restrained the 1960s merger wave.

In fact, the merger boom of the 1980s may have helped establish the junk bond market rather than the other way around. The surge in new issues of junk bonds in the late 1980s coincided with the peak in the merger boom. Some part of the demand for debt generated by the merger boom may have increased interest in junk bonds and other innovative debt instruments.
Chart 2
Junk Bond Issues and Stock Market Volatility

Note: In this chart, volatility is measured by the annual standard deviation of monthly stock returns of the Standard & Poor's index of 500 stocks.

Sources: See chart 1 (junk bond issues); Center for Research in Security Prices (stock market volatility).

Junk bonds and corporate debt

There is a striking coincidence in the growth of corporate debt and the revitalization of the junk bond market. However, the growth in outstanding junk bonds in the 1980s is not large enough to account directly for the growth in corporate debt. Junk bonds outstanding increased $189 billion from the end of 1979 to the end of 1989. Over the same period, corporate debt increased $1,322 billion. Thus, junk bonds accounted for only 14 percent of the growth in corporate debt.

Furthermore, it is difficult to say that junk bonds were more responsible for the growth in total corporate debt than any another component. During the 1980s, investment-grade bonds increased more than 100 percent, bank loans grew more than 150 percent, and commercial paper outstanding increased more than 300 percent (Board of Governors of the Federal Reserve System 1990, pp. 35-36). These three forms of debt account for two-thirds of the growth in corporate debt. Clearly, all of these forms of debt played a part in the growth.

Indeed, it is possible that the growth in corporate debt contributed to the growth of the junk bond market, rather than the other way around. A prominent trend in financial markets in the 1980s was the move toward securitization of debt, that is, a move away from intermediated, nonmarketable forms of debt, such as bank loans, and toward marketable securities, such as corporate bonds. Many of the financial innova-
Junk Bond Issues and Bond Market Volatility

Note: In this chart, volatility is measured by the standard deviation of monthly returns of the Salomon Brothers' Long-Term High-Grade Corporate Bonds Index.

Sources: See chart 2.

visions of the 1980s came to popularity as part of this trend. Junk bonds may be just another reflection of the securitization phenomenon.

Junk bonds and financial market volatility

Financial markets in the late 1980s endured some difficult times—particularly the stock market collapse of October 1987. Some observers claim the growth of the junk bond market increased financial market volatility.

One problem with this claim is the lack of an apparent relationship between the growth of the junk bond market and stock market volatility. Chart 2 shows new issues of junk bonds and stock market volatility from 1981 through 1989. Junk bond issues grew rapidly through 1986 and then leveled off. Stock market volatility was very high in 1987, thanks to the October market collapse, but was unexceptional otherwise. If there were a connection between stock market volatility and the growth of the junk bond market, stock volatility would be high throughout the late 1980s instead of just in 1987.

Furthermore, the growth of the junk bond market and volatility in high-grade corporate bond returns are inversely related. Chart 3 shows new issues of junk bonds again, but this time with the volatility of the Salomon Brothers index of long-term, high-grade corporate bonds. Bond market volatility began the 1980s at record levels and was lower thereafter. If there were a connection between bond market volatility and the
growth of the junk bond market, bond volatility would have risen rather than fallen in the late 1980s.\textsuperscript{21}

IV. Conclusion

For years, critics have blamed junk bonds for a variety of financial market ills. The merger boom of the 1980s, the rise in corporate debt, and financial market volatility in the 1980s are all traced, by some observers, to junk bonds.

The truth is that the evidence does not support these charges against junk bonds. The key premise in the case against junk bonds—the belief that junk bonds have special properties that upset financial markets—is questionable. While the junk bond market grew at the same time that financial market problems surfaced, this circumstantial link turns out to be unpersuasive. The junk bond market has accounted for only a small part of the merger boom and of the growth in corporate debt, and the growth in the junk bond market is not closely associated with the trends in financial market volatility. Of course, there may be other concerns over junk bonds; for example, it may be inappropriate for banks and thrifts to hold junk bonds. Nevertheless, the three charges against junk bonds examined in this article are not supported by the evidence.