

The Journal of FIXED INCOME

VOLUME 13, NUMBER 4

MARCH 2004

STANLEY J. KON Editor
BOBBIE GRIFFIN Editorial Assistant
PATRICIA B. PEAT Copyeditor

HARRY KATZ Production Director
MICHELLE WRIGHT Production Manager
DAVID GOMBAC Senior Staff Copyeditor
AJANI MALIK Reprints Manager

ANNE O'BRIEN Marketing Director
MICHELLE COX Marketing Manager
STEFANNY HSU Assistant Marketing Manager

DAVE GALAN Advertising Associate

ROBERT TONCHUK Fulfillment Director
VINCENT YESENOSKY Senior Fulfillment Manager
CHERLY-NINA BONNY Fulfillment Manager

DAVID E. ANTIN Director of Finance
and Operations
KAREN LEE Business Manager

ALLISON ADAMS Publisher
CHRIS BROWN CEO

The lead article in this issue of *The Journal of Fixed Income* contains information on structured finance securities. Asset-backed securities (ABS), collateralized debt obligations (CDOs), and private-labeled mortgage-backed securities are rapidly growing markets that provide significant opportunities for fixed-income managers. In particular, Hu and Cantor find that overall default rates and losses given default on structured securities have been much lower than those on corporate securities. Next, Richard Johnson provides evidence that nationally recognized agencies appear slow to signal firms' problems for rating changes from BBB-. However, a non-recognized agency is more likely to drop a firm below investment grade status.

There is considerable debate about the ability to price corporate bonds with reduced form versus structural credit risk models. Ericsson and Reneby find that the structural model's pricing performance is at least as good as those of the reduced form. Furthermore, pricing errors on individual bonds are considerably reduced (diversified) in a portfolio of bonds. In the next article, Marchesini, Perdue, and Bryan test existing prediction models of firm bankruptcy to the prediction of high-yield bond defaults. Although each of these models was not impressive, the authors improved results substantially by integrating the cash flow and accounting efficiency ratios approaches.

The major systematic effects on bonds across countries calls into question the benefits of international diversification. Hunter and Simon provide strong evidence, however, that currency-hedged bonds do provide significant diversification. The changing correlations are found to be consistent with variation in the business cycles among countries. In the next article, Sherman Davis constructs an adjustable-rate mortgage (ARM) prepayment model with incentives to refinance primarily based on ARM-to-ARM rates and from ARM to fixed-rate mortgage rates. The evidence indicated good performance for both in-sample and out-of-sample tests.

In the next article, Professor Rendleman provides a simple and accurate method for obtaining the term structure of interest rates from par yield and swap curves. The accuracy of discount rates is clearly important when valuing interest-dependent securities with cash flows that do not fall on the same dates. This is particularly relevant for trading strategies that depend on detecting the unique characteristics of bonds relative to swaps.

Finally, Chu, Pittman, and Yu find that Treasury inflation-indexed security prices in the final six months convey insightful information about the market's assessment of inflation risk. This is particularly evident during the first quarter of 2002 in which disinflation was a major concern.

We hope you enjoy this issue of *The Journal of Fixed Income*. Your continued support of the Journal is greatly appreciated.

Stanley J. Kon
Editor

©Euromoney Institutional Investor PLC. This material must be used for the customer's internal business use only and a maximum of ten (10) hard copy print-outs may be made. No further copying or transmission of this material is allowed without the express permission of Euromoney Institutional Investor PLC. Copyright of Journal of Portfolio Management is the property of Euromoney Publications PLC and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.