

# How to Strike the Right Balance in High Yield Bonds

**Strong 2016 performance and a sharp rally in credit spreads have prompted some investors to take a cautious view of high yield bonds. However, we believe this asset class remains attractive as part of a fixed income allocation, particularly as the US Federal Reserve looks to raise interest rates. The key is to approach the asset class thoughtfully.**

The surprise election of Donald Trump was a game changer. While many details of this new administration are still uncertain, the general direction is clear. The positives of pro-growth tax cuts, regulatory rollback, and infrastructure spending have to be weighed against a deleterious impact on global trade. Monetary policy remains generally accommodative. However, a shift in the Fed’s “dot plots” and more hawkish rhetoric from many Federal Open Market Committee (FOMC) members could indicate a path to higher Treasury rates that is not as far off as recently thought.

## Why consider high yield?

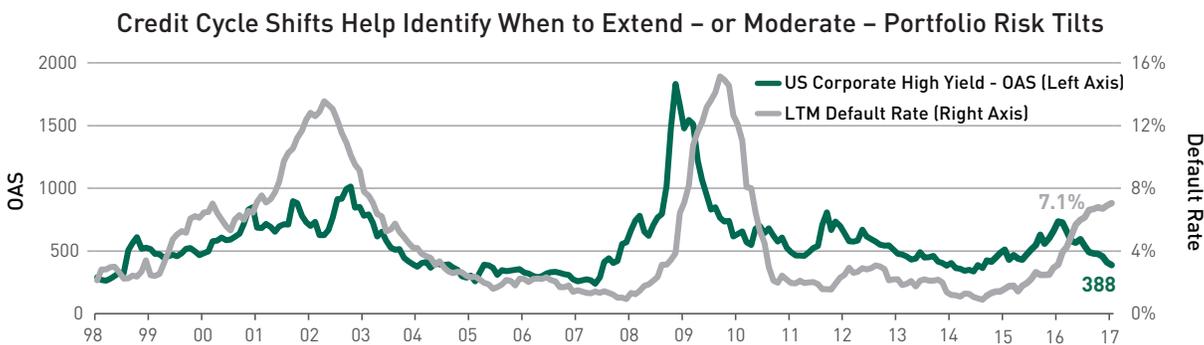
As the Fed plans to embark on its next interest rate tightening cycle, investors in traditional fixed income assets are bracing for a prolonged period of underperformance. Zero-interest-rate policy over the last several years has left many core fixed income portfolios with little yield cushion to absorb rising benchmark rates. Duration risk for bellwether core benchmarks, such as the Barclays US Aggregate Index, has also drifted steadily higher. The result is that portfolios overexposed to highly interest-rate-sensitive segments, such as US Treasuries, US agency bonds, and mortgage-backed securities, may be even more vulnerable to principal losses than they were during past rate hike cycles.

To help diversify portfolio duration risk and strengthen yield curve positioning, investors may consider a high yield bond allocation. Credit spreads are still more than double those of investment-grade corporates and mortgage-backed securities, with far less interest rate sensitivity than either of these segments.<sup>1</sup> Moreover, earnings estimates among the high yield issuer base are indicating marked improvement in 2017 as companies get a double benefit from the improving domestic economy and the potential boost of the domestic-focused fiscal policy of the new administration. Further, high yield default rates should begin to fall aggressively in the second half of 2017 to a more typical 3%-4% range, due to an improved backdrop for commodity-related credits.

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Source: Barclays, JPMorgan. US Corporate High Yield OAS: Barclays US Corporate HY Index OAS as of 31 December 2016. LTM Default Rate: JPMorgan Last Twelve Months Domestic Bond Default Rate as of 31 December 2016. We are not soliciting or recommending any action based on this material. Any views represent the opinion of the manager and are subject to change.

<sup>1</sup> Source: Barclays US Corporate HY Index as of 31 December 2016.

However, solid fundamentals are largely reflected in valuations across all asset classes. While default rates are trending lower, valuations leave little cushion to absorb periods of heightened volatility. Given the policy uncertainty related to the new Trump administration, a busy 2017 election calendar in Europe, and the prospect of a more active Fed, some vigilance is warranted. We believe investors must strike a balance in high yield, securing the highest current income while emphasizing credit quality through security selection.

### High Yield Bond Spreads Tend to Absorb Most Treasury Increases

3 Months Ending	3-Month change in 5 Yr Tsy	HY Bond Spreads Beginning of Period	Spread Tightening / Widening	HY Bond Total Return During UST Move	HY Bond Total Return - Next 3 Months
Dec-16	0.78%	480	(71)	1.8%	---
Jan-11	0.77%	575	(84)	2.8%	3.2%
Jun-09	0.90%	1514	(569)	23.1%	14.2%
May-08	0.95%	745	(123)	4.3%	-3.8%
Jun-04	0.99%	414	(20)	-1.0%	4.8%
Aug-03	1.18%	654	(143)	2.9%	6.4%
Jan-02	0.90%	882	(181)	3.9%	2.6%
Apr-96	1.18%	364	(60)	0.2%	1.9%
Nov-94	0.98%	337	(16)	-1.0%	5.6%
Apr-94	1.61%	329	9	-4.7%	1.2%
Average	1.01%	670	(108)	2.5%	3.4%
Median	0.98%	611	(80)	0.9%	2.7%

Performance when five-year US Treasuries rose 70 bps or more in three months. Source: JPMorgan as of 31 December 2016. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Past performance is not indicative of future results. Any views represent the opinion of the manager and are subject to change.

### High yield bonds have prevailed in past rate hike cycles

To illustrate the impact of US Treasury yield increases on high-yield bonds, consider how the asset class has performed during previous periods when five-year US Treasury yields increased 70 basis points or more in three months. We examined each of these occurrences over the past 25 years. High yield bond spreads absorbed 80%-100% of the US Treasury yield increase, with returns moderately affected during the period of interest rate volatility. Positive returns resumed as rate volatility typically abated over the subsequent three-month period. Consider the fourth quarter of 2016, when the yield-to-maturity on the five-year Treasury note rose from 1.15% to 1.92%, a difference of 77 basis points. During this period, high yield absorbed this Treasury move as spreads rallied 71 basis points, which provided for a total return of 1.75%.

### Higher Rated High Yield Credits Have Delivered Better Risk-Adjusted Returns

	Annualized Total Return	Standard Deviation	Sharpe Ratio
January 1987 — December 2016			
BB	8.72	6.52	0.80
B	7.64	8.61	0.51
CCC	7.21	13.83	0.33
January 1997 — December 2016			
BB	7.68	7.18	0.76
B	6.06	9.21	0.44
CCC	6.14	14.42	0.33
January 2007 — December 2016			
BB	7.83	8.44	0.85
B	6.19	10.29	0.57
CCC	6.74	15.77	0.45

Source: Bloomberg Barclays, as of 31 December 2016.

### Higher rated bonds offer greater risk/reward potential

A common perception of the high yield market is that the issuer base is filled with companies that have a meaningful risk of bankruptcy. However, history has demonstrated that the core group of issuers (BB and B rated) have a markedly better default history than the lower rated group as the majority of defaults that occur in the high yield market are attributable to CCC rated issuers. Lower rated bonds are most susceptible to default rate increases when their highly leveraged capital structures coincide with an increasing debt service burden and/or a slow-growth economic environment.

That default rates rise as credit quality declines is not a revelation to credit investors, but the magnitude of these differences by rating tier may be underappreciated. Median annual historical default rates for BB, B, and CCC rating tiers have been 0.28%, 1.42%, and 9.52%, respectively, according to Bank of America Merrill Lynch. Additionally, the lower rated tiers have tended to suffer much more in recessionary environments, generally 3x-5x or more than the default rate of the B tier. For example, in the aftermath of the 2008 financial crisis, defaults among issuers rated CCC- peaked at 34.1%, compared with 12.6% for B rated issuers and only 4.1% for BB rated issuers,<sup>2</sup> in line with the trend of previous economic downturns.

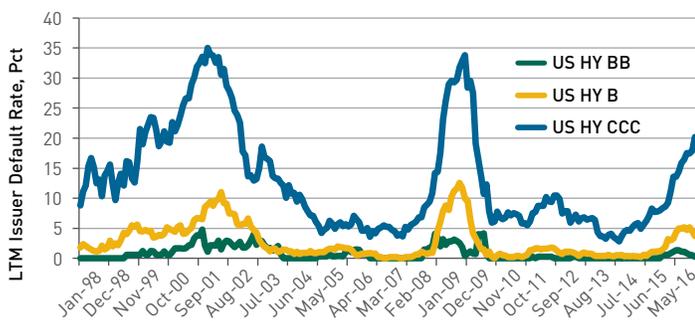
As a result, we advocate a tailored approach to the asset class depending on investor risk tolerance. Investors sensitive to volatility can achieve a reasonably attractive

<sup>2</sup> Bank of America Merrill Lynch Global Research as of 10 September 2015.

risk/return profile by focusing on the BB/B segment of the market. More return-seeking, risk-tolerant investors may consider working with a manager that uses a value-based tactical approach for the lower rated tier of the market.

Late-cycle volatility can be extreme, underscoring the value of fundamental credit research. As the global economic cycle continues to extend, investors have been increasingly skittish, with a risk-on/risk-off mentality that has been quick to punish markets after disappointing news. Price volatility can be especially high in companies with high debt leverage, typically those rated CCC. Monthly return volatility measures demonstrate reasonably similar Sharpe ratios (a measure for calculating risk-adjusted return) among ratings tiers, with the exception of CCC due to higher volatility.<sup>3</sup> Focusing on higher-rated credits has historically captured similar return and diversification

**Default Spikes Have Been Significantly Higher in Lower-Rated High Yield Issuers**



Source: Bank of America Merrill Lynch Global Research as of 31 December 2016.

benefits of the broader high yield asset class while sacrificing minimal upside and significantly reducing risk exposure, particularly during more volatile periods. Capturing the “beta” of lower rated credit may be desirable early in an economic cycle, but much of the value there has been realized and now waits for the catalyst that will initiate the next cycle.

## Why manager style and size have become increasingly important

As rates begin to normalize over the next several years, we expect security selection and alpha to play a much greater role in high yield bond portfolio returns than sector rotation and beta. The added gains and downside protection a skilled manager can deliver can be considerable, in terms of capturing both opportunistic capital appreciation and greater compounding opportunities through consistently higher income generation.

The dispersion in manager returns can be considerable. Among eVestment’s US High Yield Fixed Income Universe over the 12 months ended 31 December 2016, the fifth-percentile high yield bond strategy delivered 20.24% in total return, while the 95th percentile gained 6.58%. The annualized difference between these same percentiles for the three- and five-year periods was around 350 and 480 basis points, respectively.<sup>4</sup>

To help assess an investment manager’s ability to deliver stable alpha and limit default loss, investors can evaluate:

- **The strength and breadth of research capabilities.** The growth of the leveraged finance markets and increasing complexity of its issuers requires significant resources. The right people and experience are required to perform bottom-up analysis of a large issuer base in order to uncover opportunities across industries.
- **Whether the investment process is disciplined and repeatable.** Securing steady outperformance in high yield requires a consistent investment process that properly balances risk and return. Managers should have consistent track records of being appropriately compensated for the portfolio’s credit risk.
- **The manager’s experience across full credit cycles.** Understanding when and how to shift portfolio risk as the credit cycle evolves can be crucial. Managers should have proven experience navigating both favorable and difficult past markets.

Overall, we believe the case for including high yield bonds in a fixed income portfolio remains compelling due to better resilience in the face of rising interest rates. As always, managers with strong investment processes will be better equipped to manage the risks inherent in the market.

<sup>3</sup> Bank of America Merrill Lynch Global Research as of 10 September 2015.

<sup>4</sup> Source: eVestment Alliance (eASE Analytics) as of 31 December 2016. The peer group is the eA US High Yield Fixed Income Universe. The peer group had 208 members in the one-year period, 194 members in the three-year period, 174 in the five-year period, and 81 in the since-inception period.

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