

High Yield Bonds – Junk or Genius?

Introduction

High yield is much maligned and misunderstood asset class. One of the most interesting aspects of being a specialist manager in this asset class is that most people we speak to automatically associate the words 'high yield' with the word 'junk'. Perhaps we shouldn't be surprised as almost every time 'high yield' appears in the media, the word 'junk' is not far behind.

Obviously, 'junk' is a pejorative term. It suggests an asset class full of low quality securities issued by shaky companies, which is therefore highly risky and volatile and to be avoided at all costs. As an active manager of high yield bonds, you might think we deplore the use of such sobriquets. Actually, it can work in our favour.

The truth is that high yield bonds have very attractive risk/return characteristics and strong diversification benefits. However, the fear and misunderstanding prevalent around high yield makes this one of the least efficient asset classes. This market inefficiency creates opportunities that good active managers can exploit.

High Yield – An Inefficient Asset Class

There is an almost arbitrary distinction between the supposedly safe, secure world of investment grade bonds (those with a credit rating of AAA to BBB-) and the supposedly dangerous, risky and volatile world of high yield, or sub-investment grade (those with a credit rating below BBB-). Many investors cannot hold bonds that fall into the high yield category, so there is an inefficiency created around this investment grade/high yield line.

Credit ratings have also come under fire recently as events have shown that investors in structured products can go to bed holding AAA rated paper and wake up holding CCC rated paper. In such an uncertain environment it pays to look beyond the rating.

The most common misconceptions about high yield are:

High yield is volatile: US high yield bonds have delivered returns of around 9.3% per annum in US\$ terms since September 1990, with volatility of around 6% (Source: Merrill Lynch). During the period from 01/06/2007 to 29/02/2008 (the recent 'credit crunch') US high yield bonds have fallen in value by 2.81%, compared with a fall of 14.66% in the MSCI World Index (Source: Bloomberg, Morgan Stanley Capital International, Merrill Lynch). In reality, high yield is a remarkably resilient asset class which can help to reduce portfolio volatility as well as enhancing returns.

It's important to bear in mind that credit spreads can widen either because credit yields rise (and therefore prices fall), or because government bond yields fall, or both. In recent months government bond yields in the US and Europe have fallen significantly as a flight to quality took place, contributing to the spread widening we have seen in credit.

High yield is highly correlated with equities: High yield bonds have a correlation of around 0.4 with equities. In other words, fairly low correlation.

High yield has high default rates: The long term average natural default rate for high yield bonds is around 5.5% per annum since 1970 (Source: Deutsche Bank). Of course default rates are higher than in investment grade bonds, but generally high yield spreads have compensated for the additional default risk, apart from in bonds rated CCC and below.

A specialist high yield manager should have the resources and experience to thoroughly analyse each company and thereby minimise defaults in portfolios. By doing this, the risk-adjusted returns from high yield can be significantly enhanced.

High yield bonds are complex: High yield bonds are simply bonds with a credit rating below BBB-. They are no more complex than investment grade bonds.

The High Yield Market – Where are We Now?

We expect that the trade-off for the large amount of liquidity being injected into the financial system by governments worldwide as a result of the 'credit crisis' will inevitably be higher inflation. High yield bonds provide a good hedge for inflation because they pay high coupon income which helps to offset the impact of rising prices, and they are also typically short duration (around 4 years). In previous periods of high inflation, high yield bonds have outperformed both government bonds and investment grade corporate bonds.

Following the events of recent months, high yield bonds are now priced at levels that imply far higher default rates than we expect. Defaults will undoubtedly rise from the current very low level, but there are two points to bear in mind. Firstly, a large proportion of new issuance in 2006/2007 was in the CCC rating area, and we believe that these companies are likely to see the most stress as they tend to be more highly leveraged. In addition, high yield credit spreads* are currently around double the spread required to compensate for default risk.

This offers investors an excellent opportunity to invest in high yield bonds and achieve potentially very attractive returns over the next few years. However, we strongly advocate allocating to high yield with a manager that has the resources and experience to carry out thorough bottom-up analysis, and focuses on the BB/B ratings area, which has typically provided the best risk/return trade off.

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*Credit spread is the additional return earned for taking credit risk. It is the difference between the yield on corporate bonds and the yield on government bonds of similar maturity.

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