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INVESTMENT RESEARCH

Giving credit its due

Corporate high yield bonds have come a long way from their "junk" status in the 1980s. What was once viewed as a risky market made up of formerly investment grade issuers fallen on hard times has evolved into an attractive, competitive place to raise capital. In 1986, the corporate high yield market was $58.6 billion in size.[1] Today, that market has grown to $1.21 trillion.[2]

We are not going to deny that, as an asset class, high yield bonds are inherently riskier than their investment grade counterparts. Instead of contrasting them, however, we think it is beneficial to examine how these asset classes work together in a portfolio context. In this paper, we show why we believe high yield bonds deserve a long-term, strategic allocation in most portfolios.

We see three main purposes that high yield bonds serve in a well-diversified portfolio:

1. Diversify core fixed income allocations
2. De-risk equity allocations
3. Improve overall risk/return statistics

Diversify core fixed income allocations

The benefits of a properly diversified portfolio have been well documented. When considering an equity allocation, for example, investors would generally not want to be over-concentrated in one position, or even in one style (value, growth, blend) or market cap (small, mid, large). Intra-asset class diversification is important, and not just for equities. When it comes to fixed income, we believe it's equally important to consider varying maturities, credit qualities and interest-rate and business-cycle sensitivities. A properly diversified portfolio cannot guarantee gains or ensure against losses, but it can help to deliver the portfolio with the best potential returns given an investor's desired level of risk.

High yield bonds present a compelling case for inclusion as an effective fixed income diversifier. They have historically had negative correlation to U.S. Treasuries (-0.15) and low correlation to traditional fixed income products like investment grade bonds, including exclusively U.S. corporates (0.55) and diversified investment grade, as represented by the Barclays Agg (0.18).[2]

Investment Research

Robert Hoffman, CFA
Executive Director

Lara Rhame
Chief U.S. Economist

Andrew Korz
Associate

Kara O'Halloran, CFA
Associate

Contact
research@fsinvestments.com

1 Bloomberg, as of September 30, 1986.

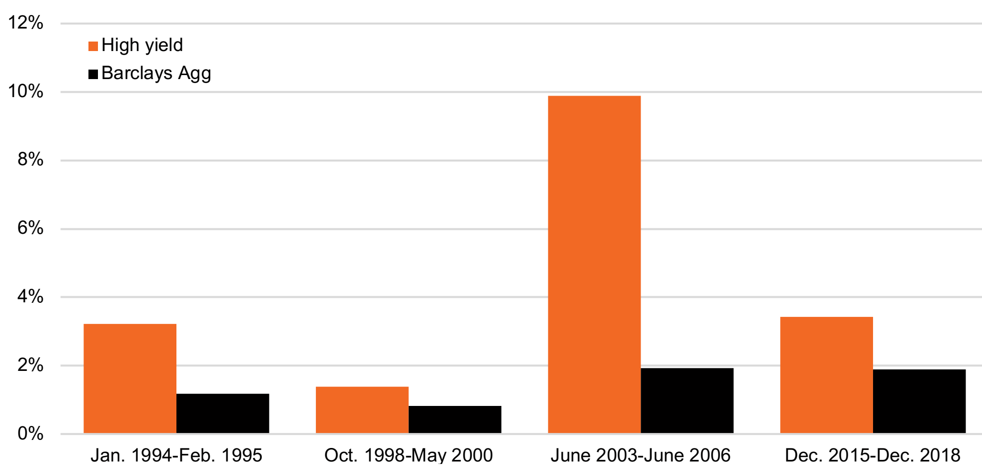
2 Bloomberg, as of September 30, 2019.

CORRELATIONS	1	2	3	4	5
1 ICE BofAML U.S. High Yield Index	1.00				
2 ICE BofAML U.S. Treasury Index	(0.15)	1.00			
3 ICE BofAML U.S. Corporate Index	0.55	0.63	1.00		
4 S&P 500	0.63	0.27	0.22	1.00	
5 Barclays Agg	0.18	0.92	0.86	0.05	1.00

High yield bonds are also less sensitive to changes in interest rates, helping to diversify fixed income allocations from one of their primary drivers of volatility. Rising rates typically send bond prices down, resulting in potentially negative returns for fixed income investments, but they have a different impact on high yield. Generally, periods of rising interest rates accompany a period of stable to increasing economic growth, with increasing corporate earnings and improving credit fundamentals. Because issuers of high yield bonds are better able to meet their financial obligations during these periods, they tend to coincide with falling default rates, a positive for corporate high yield bonds. The resulting decrease in the risk premium for high yield bonds in this environment typically offsets the moderate price effects of the rate increases, and high yield bonds perform well despite rising rates. The past 25-year bull market in bonds has seen four Fed tightening cycles. As shown below, in each of these, high yield has outperformed core fixed income.

While high yield may be expected to underperform core fixed income during periods of economic weakness and falling rates, it's also important to acknowledge the current interest rate environment. With rates currently at historic lows, core fixed income prices have little room left to rise, arguably reducing the relative attractiveness of core fixed income as a buffer to portfolios if volatility in risk assets increases.

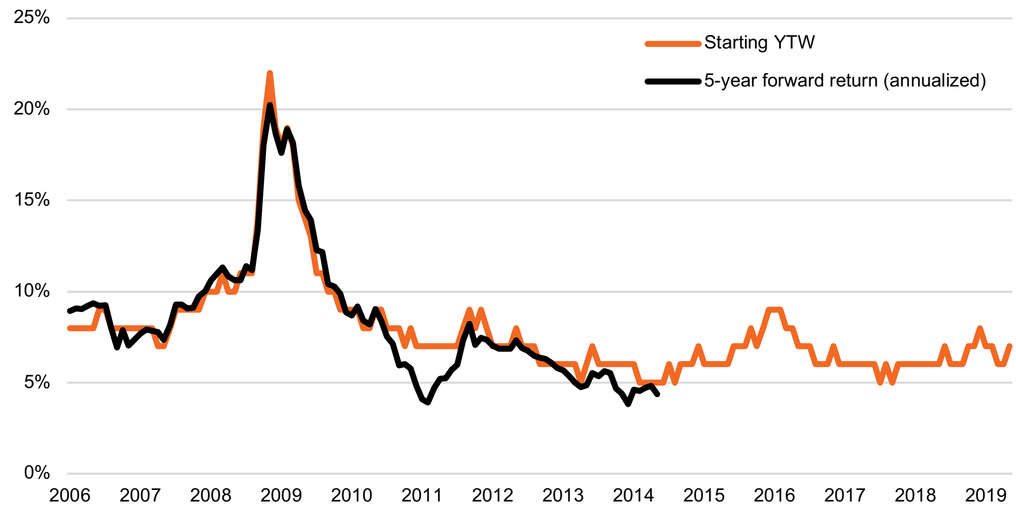
HIGH YIELD VS AGG PERFORMANCE



Source: ICE BofAML U.S. High Yield Index, Bloomberg Barclays U.S. Aggregate Bond Index.

Although high yield is relatively interest rate agnostic and is more sensitive to the business cycle, we argue that market timing is unnecessary if allocations are held through a credit cycle. (See more on this in our previous high yield research piece.) In fact, as shown in the chart below, when held for at least five years, the starting yield-to-worst on the high yield bond index has consistently been a good proxy for expected forward returns.

HIGH YIELD YTW VS. 5-YEAR FORWARD RETURN

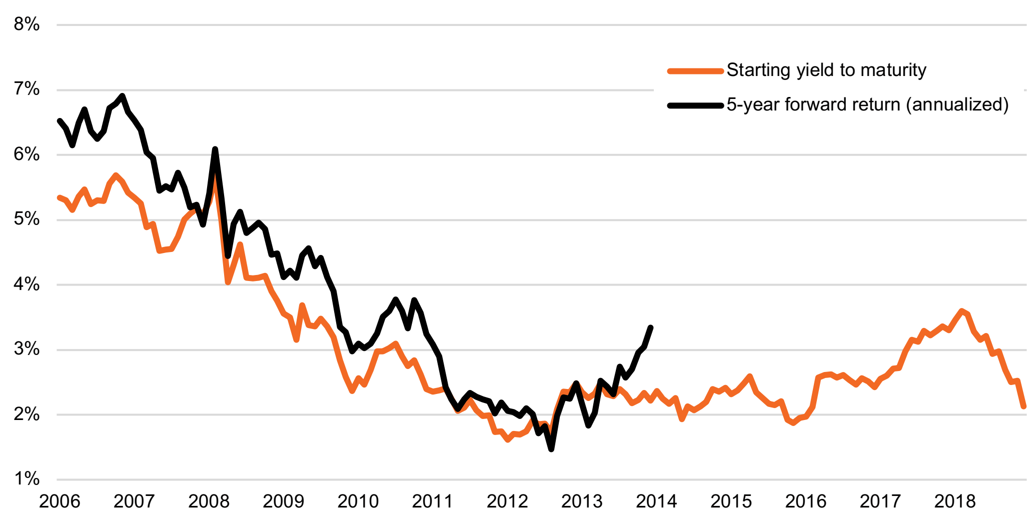


Source: ICE BofAML U.S. High Yield Index.

What drives this relationship? In tightening spread environments, investors benefit from price appreciation. In times of widening spreads, they benefit from the ability to reinvest payments at higher coupons. While defaults and losses may occur on individual bonds, in general the income or coupon payments on high yield bonds has been sufficient to offset losses over past cycles.

The relationship between yield and return does not only apply to high yield bonds. The yield on core fixed income, represented by the Barclays Agg, has also been a reliable indicator of returns.

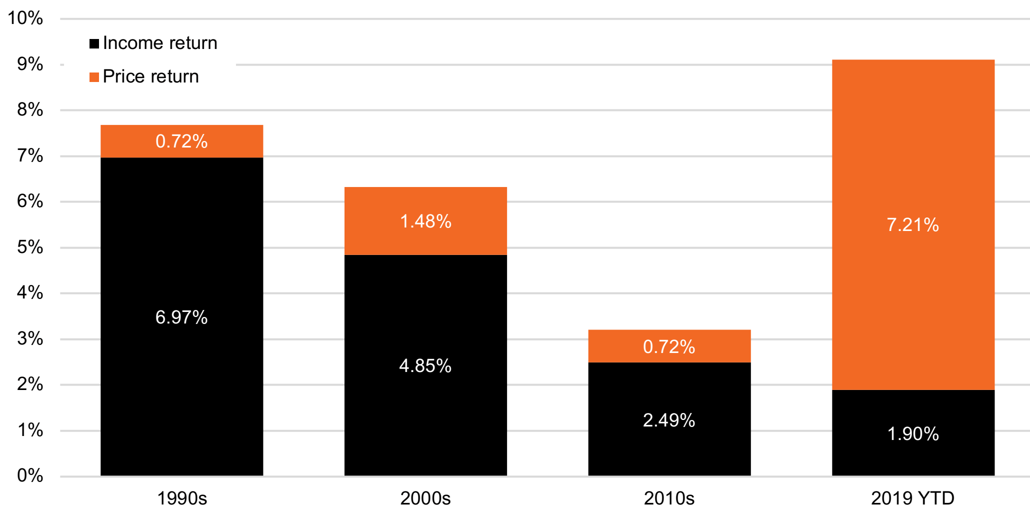
BARCLAYS AGG YTM VS. 5-YEAR FORWARD RETURN



Source: Bloomberg Barclays U.S. Aggregate Bond Index.

For much of the past 30 years, yield was the dominant component of core fixed income returns. Over time, however, this dynamic has started to shift – a far greater percentage of core fixed income returns this year has come from price return. With the current yield of the Barclays Agg at just 2.26%,[2] we believe this shift may further bolster the case for high yield as a fixed income diversifier and return enhancer.

BREAKDOWN OF BARCLAYS AGG TOTAL RETURNS OVER TIME



Source: Bloomberg, as of August 31, 2019.

De-risk equity allocations

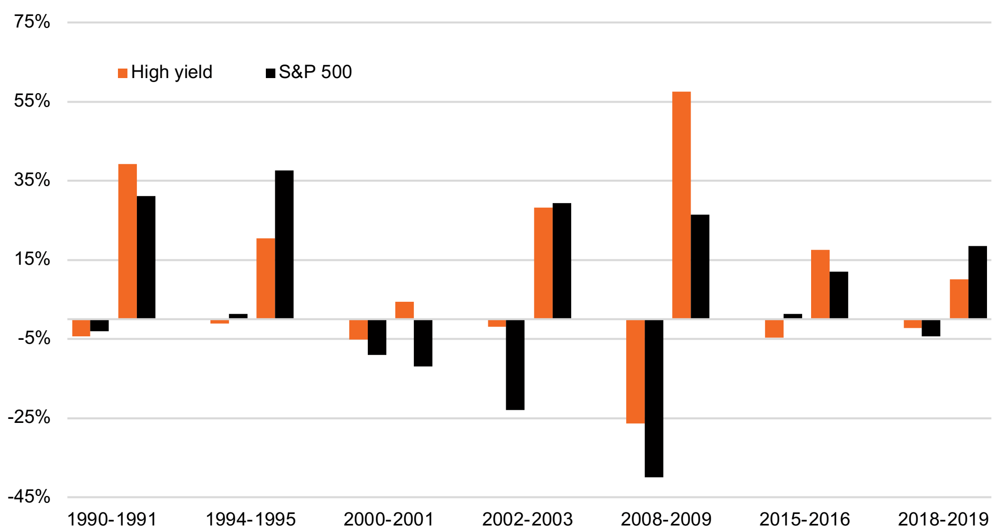
While high yield bonds have a fairly low correlation to core fixed income, as shown above, they do have a moderately high correlation to equities. Given that relationship, many investors may view high yield bonds as a component of a diversified equity allocation rather than viewing high yield bonds as a complement or diversifier to traditional fixed income. Through that lens, it's valid to question if the potentially lower expected return of owning bonds versus equities compensates investors for the potential equity-like risk of high yield bonds. Said another way: Can high yield bonds offer an attractive enough risk-adjusted return to warrant a piece of an equity allocation?

	RETURN	VOLATILITY	SHARPE RATIO
High yield bonds	7.48%	8.29%	0.66
S&P 500	9.83%	14.56%	0.54

The data over the last 25 years suggests the answer to this question is yes. Over this time period, high yield bonds have exhibited better risk-adjusted returns than equities, with the S&P 500 returning an annualized 9.83% with 14.56% volatility and high yield bonds returning 7.48% with 8.29% volatility.[2] That's 80% of the return with just over half of the volatility. Corporate high yield bonds have allowed investors to remain exposed to the profits and growth of corporate America, with downside protection provided by the more senior position of bonds versus equities.

High yield bonds have also exhibited compelling return characteristics following periods of negative return. There have only been seven individual calendar years with negative returns since 1984, and never two consecutively. On average, high yield bonds lost less and recovered more – resulting in higher cumulative returns for high yield bonds versus equities over these two-year periods.

YEARS OF NEGATIVE RETURN AND SUBSEQUENT RECOVERIES

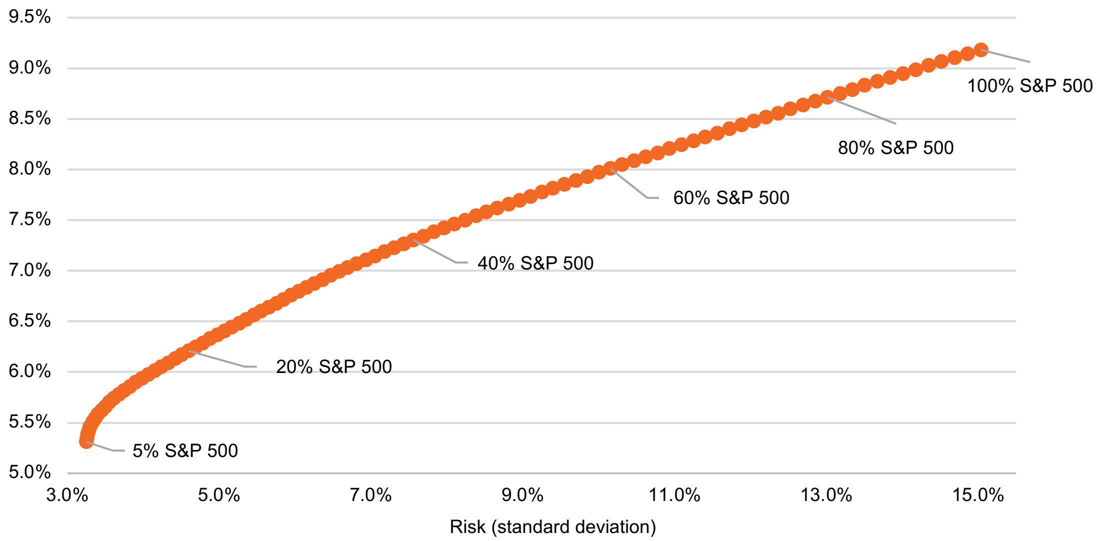


Source: ICE BofAML U.S. High Yield Index.

Improve overall risk/return statistics

If high yield bonds can represent either a diversifier for core fixed income exposure or a complement to an equity allocation, what type of allocation is suggested based on the risk/return statistics? After all, if fixed income returns are better achieved through core fixed income allocations and equity-like returns are best obtained just from equities, then an efficient frontier analysis would show no place for corporate high yield bonds. We believe this analysis shows otherwise. An efficient frontier analysis run using returns since 1997 including stocks (represented by the S&P 500), core fixed income (represented by the Barclays Agg), investment grade corporate bonds (represented by the ICE BofAML U.S. Corporate Bond Index) and high yield bonds (represented by the ICE BofAML U.S. High Yield Index) indicates an allocation to high yield bonds at nearly every point on the frontier. Depending on an investor's risk tolerance, approximated by a given allocation to equities, portfolios along the efficient frontier include an allocation to high yield bonds broadly ranging from 2%–16% of an investor's overall portfolio. A 60/40 portfolio, with 60% allocated to equities, includes a 11% allocation to high yield bonds.

EFFICIENT FRONTIER



Source: Zephyr, as of June 30, 2019.

EQUITY ALLOCATION	HIGH YIELD ALLOCATION	INVESTMENT GRADE CORPORATE ALLOCATION	CORE FIXED INCOME ALLOCATION
100%	0%	0%	0%
80%	16%	4%	0%
60%	11%	29%	0%
40%	6%	54%	0%
5%	2%	0%	93%

Summary

We believe investors need to look at high yield bonds in a new light. Specifically, we see three uses for high yield bonds in a portfolio context:

1 Diversify core fixed income allocations

2 De-risk equity allocations

3 Improve overall risk/return statistics

We believe the ability of high yield bonds to both enhance income and improve portfolio returns, while potentially decreasing overall risk as a component in a diversified portfolio, should eliminate the “junk” stigma they have long endured.