

# HIGH YIELD: Strategic solution for uncertain times

By Sadhana Valia, CFA and Lori Marchildon, CFA

Management consultant Tom Peters once said “If you’re not confused, you’re not paying attention.” In the aftermath of the last two years and uncertainty looking forward, this observation seems particularly relevant for investors and fund managers. In such circumstances, it is best to let the facts speak for themselves. Two trends are emerging: First, after living through excessive equity volatility, investors are decreasing allocations to equity; second, investors are searching for yield in this near-zero rate environment. The facts are leading investors’ attention to spread products but they remain wary of structured securities. Against this backdrop, high yield bonds – the ultimate spread asset class – is gaining popularity as a strategic part of a balanced asset mix. High yield offers benefits on four levels – long term risk and reward characteristics, diversification, positive outlook, and attractive asset class features.

### Three decades of attractive risk /reward characteristics

After the whirlwind of the last two years, investors are going back to first principles – assessing asset classes based on long run risk and return metrics. High yield is popping up on their radar given its attractive risk and return characteristics over the past three decades. As expected,

high yield exhibits characteristics of both equity and fixed income. High yield’s average annual long run return of about 10.65% (over 1980 – 2009)<sup>1</sup> is more than respectable when compared to the average annual returns from equity markets over the same period (e.g., S&P 500 Index is up just over 11.23% on a U.S. dollar basis). But the impressive fact is that the high yield market achieved this return with just over half the volatility. This results from the healthy contractual coupon providing a cushion in down markets. Bonds also rank higher in the pecking order if a company goes bankrupt, providing more downside protection. Aside from an unprecedented 2008, in 30 years high yield has only had three distinct years of negative performance. These features are ideal for investors targeting particular return benchmarks while focusing on capital preservation and minimizing downside risk.

### Two way diversification

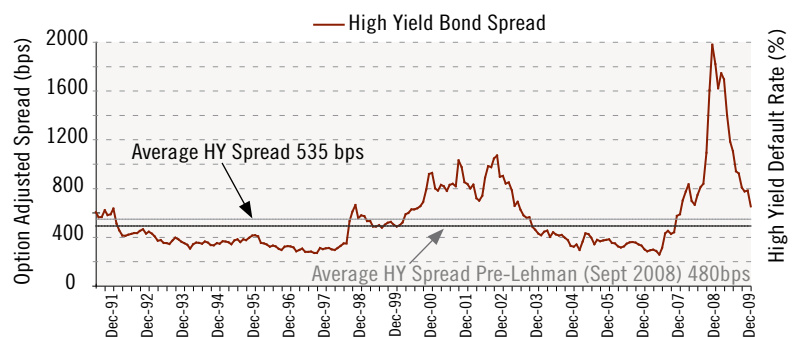
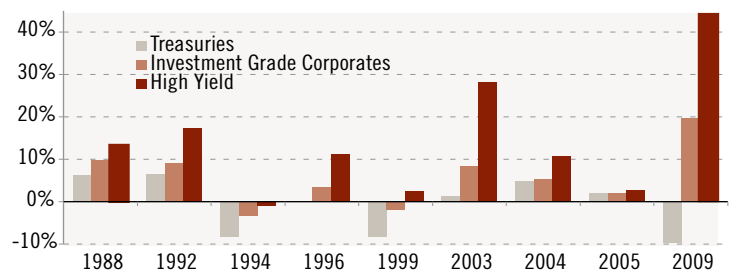
High yield offers diversification benefits on two fronts – low correlation to other core asset classes and low sensitivity to rising rates. The former means an allocation to high yield potentially increases returns while reducing overall portfolio volatility – always an attractive feature. However, it’s the latter that makes high yield especially compelling these days.

Investors are struggling with portfolio positioning in a low rate environment with the prospect of rising rates down the road. With an average modified duration of 4.3 years, high yield is much less sensitive to rising interest rates than other fixed income asset classes where duration is much higher. Looking back, history shows us that in years where interest rates increased, high yield performed very well. In the past 20 years, rates rose in nine of those years and high yield handily outperformed other core fixed income asset classes. In eight of those years, high yield returns were in positive territory, often exceeding 10%.

### Medium term outlook is positive

In many ways, 2009’s rally (Merrill Lynch US High Yield Master II Index advanced 57.51%) is a reaction to an overdone selloff in 2008, on top of a positive trend in market supply and demand dynamics, as inflows into the asset class continued to mount. Looking forward, the case for high yield remains compelling, with spreads remaining well above the historical average of 535 bps. Fundamentally, 2008 saw issuers focused on substantive balance sheet repair. In addition, open primary markets have enabled companies to refinance their debt and markedly improve its liquidity, while the pace of defaults is already beginning to slow.

Comparative returns of fixed income asset classes in years when interest rates increased



Inflows into the asset class are likely to continue for a number of reasons. First, pension funds are moving away from equity to focus more on liability-driven investments. These longer duration strategies often include high yield to provide alpha over core fixed income returns. Second, funds' cash balances remain high, including still record asset levels in money market funds. This paints a positive technical picture for high yield as investors search for yield – still attractive at 9.1% at year end (Merrill Lynch US High Yield Master II Index).

From a macro perspective, consensus view is for a modest economic recovery over 2010 and 2011. In this scenario, corporate bonds are expected to perform well relative to other asset classes. Issuers don't necessarily need excessive growth to continue paying their coupons. Moreover, high yield participates in the

upside in a positive growth scenario while providing downside protection in a low or negative growth outcome.

#### **Deep, liquid asset class**

Pension funds, insurance companies, retail investors – to name a few – continue to turn to high yield as they seek out incremental returns on fixed income without gut wrenching volatility. With a market size of close to US\$1 trillion across 1000 issuers, high yield is a very deep market that offers pricing transparency and liquidity.

In high yield, one size does not fit all. Bonds span from lower risk BB-rated to higher risk CCC-rated issues, making it possible to construct portfolios geared to an investor's unique risk preferences and return objectives. Many investors assume high yield is risky and many investors are indeed looking for higher

beta returns. However, it is also important to understand that it is possible to build a diversified, high-quality high yield portfolio that actually exhibits similar volatility to an investment grade portfolio. You don't need to shoot for the fences to achieve a good return.

It is a very difficult time to make asset allocation decisions. Reviewing the facts provides clarity. The facts pertaining to high yield show that this is an asset class worth consideration on four levels – attractive risk/reward characteristics, diversification, positive outlook, and asset class features. Strategically allocating high yield to a balanced portfolio builds on these benefits, providing incremental yield over a core fixed income portfolio while being geared to an investor's risk appetite.

<sup>1</sup> *Credit Suisse High Yield Index II*

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Note for chart 1:

Treasuries- Merrill Lynch 10 year

Investment Grade- Merrill Lynch Corp. Master

High Yield- Merrill Lynch US High Yield Master II Index

Source: Merrill Lynch

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