Janus Henderson
INVESTORS

THE CASE FOR HIGH-YIELD BONDS

AT A GLANCE

High-yield corporate bonds have historically offered an attractive source of yield, which in turn has contributed to competitive total returns.

Occupying the center ground between investment-grade bonds and equities from a risk-return perspective, they offer the potential for diversification in a portfolio and have historically been less sensitive to interest rate risk.

A reference guide to credit ratings

	Moody's	S&P	Fitch	Definition
Investment-grade	Aaa	AAA	AAA	Highest quality
	Aa1	AA+	AA+	Very high credit quality
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	High credit quality
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Good credit quality, adequate capacity to meet financial commitments
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	
Sub-investment grade (high-yield)	Ba1	BB+	BB+	Speculative grade, less vulnerable in the near term but faces uncertainties
	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	Highly speculative, more vulnerable to adverse business conditions but currently has capacity to meet financial commitments
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Substantial credit risk, low margin of safety and dependent on favourable business and economic conditions
	Caa2	CCC	CCC	
	Caa3	CCC-	CCC-	
	Ca	CC	CC	Default probable with some prospect of recovery
		C	C	Near default
	C	D	RD/D	In default

Source: Janus Henderson Investors, as of 30 September 2022. Aggregated definitions are a concise interpretation of the definitions from the credit rating agencies but are not those of a specific agency per se. Credit ratings can vary over time and are not a guarantee of an outcome for a bond.

What is a high-yield bond?

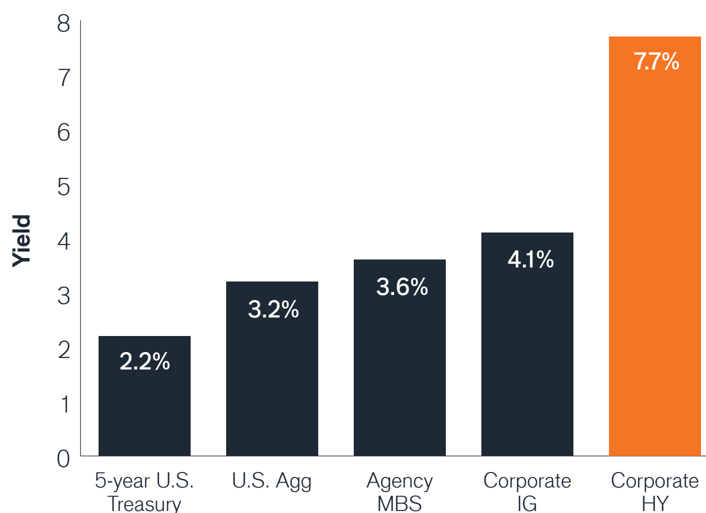
Companies issue corporate bonds to raise funds, promising to pay the investor interest (the coupon) each year and repay the par value of the bond when the bond matures. High-yield bonds are corporate bonds that carry a sub-investment grade credit rating. This means they are rated equal to or lower than Ba1 by Moody's or BB+ by S&P Global Ratings or Fitch, the credit rating agencies. They are typically issued by companies with a higher risk of default (the failure to meet repayments to bondholders), which is why they offer higher yields to attract investors.

The high-yield bond market is well developed and established, having its origins in the U.S. more than 40 years ago. Today, the $1.45 trillion U.S. high-yield market comprises a vast range of issuing companies, from large enterprises such as Carvana, American Airlines, and Twitter, to small and medium-sized companies that are raising funding via the bond markets for the first time.

An attractive source of income

Following prolonged periods of unconventional policy measures by central banks, such as asset purchasing schemes and "lower for longer" policy rates, yield profiles have since evolved to reflect new challenges in markets and the change in direction away from accommodative policies. Throughout these regime changes, high-yield bonds have continued to provide higher average yields relative to other forms of debt, as Figure 1 demonstrates.

Figure 1: Average 20-year yields on different types of fixed income



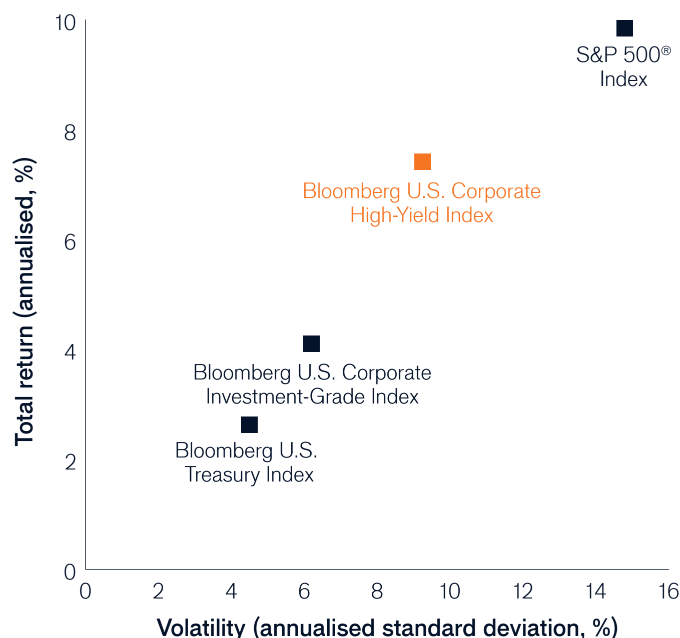
Source for high-yield market size and example constituents: Bloomberg, full market value in U.S. dollars, as of 30 September 2022. Constituents may vary over time.

Source for chart: Bloomberg, as of 30 September 2022. Indices used to represent asset classes: Agency MBS (Bloomberg U.S. Agency MBS Index), U.S. Agg (Bloomberg U.S. Aggregate Bond Index), Corporate IG (Bloomberg U.S. Corporate Bond Index), Corporate HY (Bloomberg U.S. Corporate High-Yield Bond Index). 20-year average yield to maturity for government bonds, 20-year average yield to worst for corporate bonds, as of 30 September 2022.

Risk and reward

From a risk-return perspective, high-yield bonds are typically seen as occupying the space between investment-grade bonds and equities. As Figure 2 shows, over the last 20 years, high-yield bonds have outperformed government bonds and investment-grade corporate bonds, and are not far behind equities, albeit with lower volatility than equities. This argues for a strategic allocation to high-yield bonds in diversified portfolios. The high income element in high-yield bonds has been a valuable component of total risk-adjusted return.

Figure 2: Total return versus volatility (September 2002 to September 2022)



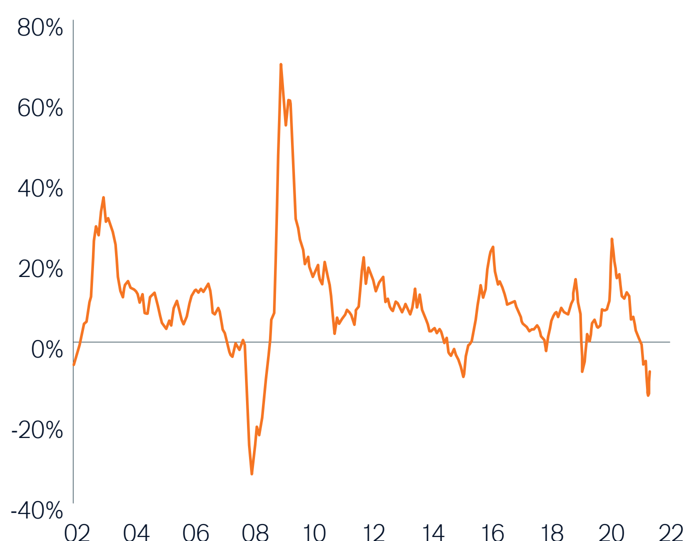
Source: Morningstar. © Morningstar, all rights reserved. Total return indices, as per Figure 1, 30 September 2002 to 30 September 2022. Volatility is standard deviation, using monthly data returns.

Past performance does not predict future returns.

While typically not as volatile as equities, high-yield bonds are issued by companies that are often sensitive to the economic cycle and to events within individual sectors and companies. Holding a diverse portfolio of high-yield bonds can help an investor reduce the idiosyncratic risk of an individual bond. High-yield bond investors should be prepared to accept some volatility. For example, during the financial crisis, the global high-yield bond market experienced a drawdown (peak to trough decline in value) of 36%[1]. Historically, however, the high-yield market has a tendency to bounce back strongly after sharp falls as demonstrated in Figure 3.

Figure 3: Bloomberg U.S. Corporate High-Yield Index

12-month rolling returns



Source: Bloomberg. Monthly rolling 12-month total returns, in U.S. dollars, 30 September 2002 to 30 September 2022.

Past performance does not predict future returns.

Low sensitivity to the interest rate cycle

High-yield bonds have typically been less sensitive to rises in interest rates or inflation because the spread (additional yield over a government bond of equivalent maturity) often acts as a cushion, absorbing some of the rise in yields when government bond yields rise or interest rates rise. The combination of higher yields and shorter maturities means that high-yield bonds have typically had lower duration (sensitivity to interest rates) than other types of fixed income.

Figure 4: Duration within fixed income

	Duration (years)
Corporate HY	4.1
U.S. Treasuries	6.0
U.S. Agg	6.1
Corporate IG	7.0

Source: Bloomberg, as of 30 September 2022. Indices as per Figure 1.

[1] ICE BofA Global High-Yield Bond Total Return Index, 21 May 2008 to 12 December 2008. Incidentally, the index had recovered its 21 May 2008 peak value by 5 August 2009.

As the correlation table below demonstrates, high-yield has had a low correlation with U.S. Treasuries, offering the potential as a diversifier within a fixed income portfolio.

Figure 5: Correlation of asset classes (September 2002 to September 2022)

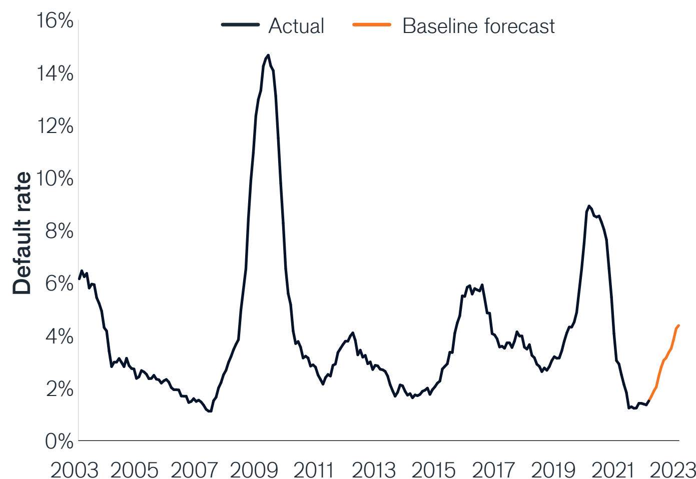
	Corporate high-yield	Corporate investment-grade	U.S. Treasuries	S&P 500®
Corporate high-yield	1.00			
Corporate investment-grade	0.64	1.00		
U.S. Treasuries	-0.09	0.58	1.00	
S&P 500®	0.71	0.39	-0.18	1.00

Source: Bloomberg, indices as per Figure 1, correlation coefficients of monthly total returns in U.S. dollars, 30 September 2002 to 30 September 2022.
Past performance does not predict future returns.

Default rates and credit ratings

For a long-term investor, the increased risk of default is the key driver of spread for high-yield bonds. Defaults shrank close to their historical lows following unprecedented levels of stimulus in the wake of the COVID-19 pandemic (see Figure 6). Meanwhile support measures and fiscal stimulus contributed to a technical backdrop in which bond issuance reached record levels thanks in part to inexpensive funding. While defaults remain low, 2022 has been a turning point in monetary policy, as central banks seek to tackle runaway inflation figures through reduced money supply and accelerated interest rate hikes. The legacy of low financing costs is evident today in reasonably strong corporate fundamentals and bolstered company balance sheets.
This should help to alleviate stresses that may transpire in the near term from a softening economic backdrop, although fundamentals could deteriorate if earnings and cash flows come under sustained pressure. Arguably, navigating this new landscape requires a selective approach to investing with a focus on rigorous fundamental research and an approach to risk that aims to avoid defaults while generating strong risk-adjusted returns.

Figure 6: U.S. speculative grade default rate, trailing 12 months



Source: Moody's Default Report, 31 July 2003 to 31 August 2023. Moody's forecast at 13 October 2022 for the year to 31 August 2023. Forecasts are estimates only and are not guaranteed.

The policy response to multi-decade inflation highs has come at a time of pre-existing geopolitical tensions; the Russia-Ukraine conflict is aggravating an energy crisis while COVID-19 restrictions continue to cause ongoing economic disruption, most notably in China. These events have generated high levels of volatility within markets, with bond spreads moving away from historical lows and driving dispersion among issuers across all credit qualities. Greater risk aversion has seen demand for credit risk assets come down, but corporate debt issuance has also slowed significantly as funding costs increase, creating a reasonably well-balanced technical backdrop. Furthermore, the lack of supply (net bond issuance) indicates that many companies have enough cash on hand to cover their current obligations.

The crossover space that encompasses BBB-BB rated bonds sits across both investment-grade and high-yield bonds and can be a source of returns as mispricing is often found in this space. Economic disruption can lead to changes in credit ratings during periods of both market strength and weakness. Investment-grade bonds downgraded into the high-yield space (so called “fallen angels”) can provide attractive risk-return opportunities if carefully selected. Bonds moving out of the high-yield space into investment-grade (so called “rising stars”) often benefit from demand formed by entering into investment-grade indices.

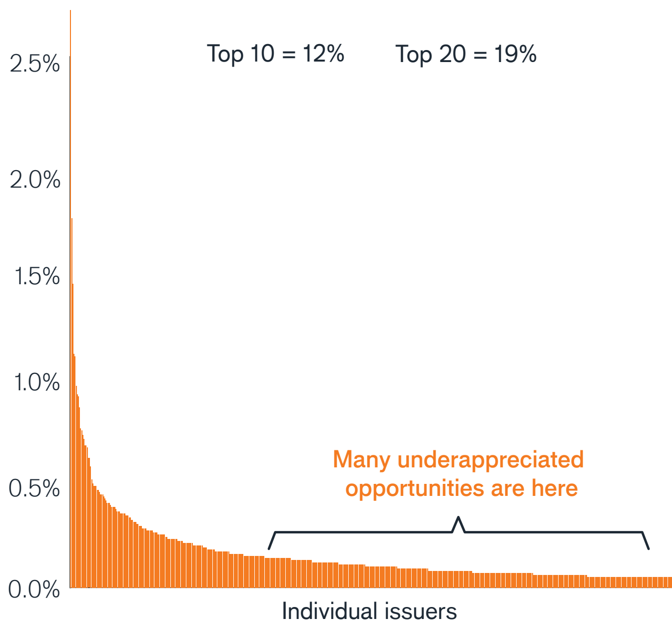
Opportunities for credit selection

High-yield tends to exhibit a higher level of idiosyncratic risk, with individual company factors proving a more significant determinant of the bond price than is the case for investment-grade bonds. The high degree of idiosyncratic risk in high-yield bonds means good credit analysis can be rewarded, making it fertile ground for active managers.

Under-researched issuers

Exchange-traded funds (ETFs) and larger investors focus the bulk of their trading activity on the larger issuers due to their size. This leaves opportunities for active managers to identify value among the smaller under-researched issuers.

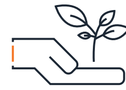
Figure 7: Issuer weights in U.S. high-yield



Source: Bloomberg U.S. Corporate High-Yield Index, as of 30 September 2022. Chart is for indicative purposes only.

Cross-border and crossover

There has been an increase in cross-border issuance, with companies issuing in a country or currency outside their domicile (for example, U.S.-based companies issuing euro-denominated bonds to take advantage of lower yields in Europe), creating opportunities for investors with global coverage. In addition, movement of bonds between investment-grade and high-yield (fallen angels and rising stars) can create opportunities to profit from mispricing and forced selling as bonds move between indices.



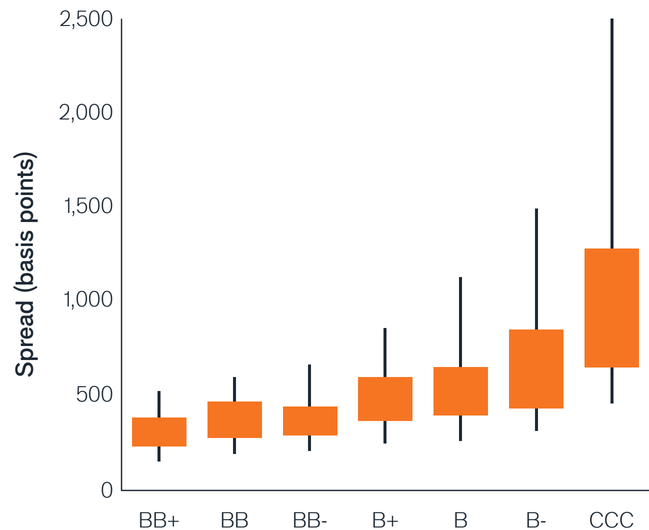
ESG factors

Environmental, social, and governance (ESG) factors are playing an increasingly important role in assessing the risks and opportunities that companies are facing. A thorough assessment of individual issuers can identify those that are on the right side of change and, therefore, are in a potentially stronger position to remain commercially relevant and able to meet their obligations to bondholders.

Breadth within each rating band

The market can hold very different views about issuers within the same rating band as demonstrated by the wide spread range in Figure 8. This means that it is possible, through careful credit analysis, to profit from mispricing or volatility in credit spreads.

Figure 8: Range in spreads offers opportunities



Source: Bloomberg U.S. Corporate High-Yield Index, as of 30 September 2022. The chart shows the interquartile range (orange box) and 5th/95th percentiles by rating category (black line). Spreads may vary over time.

Different types of bond and the capital structure

In addition to the variety in issuing companies there is also variety in the types of high-yield bond. Some of the most common are: ordinary cash bonds, which are the “plain vanilla” bonds that pay a fixed coupon and mature at a set date; callable bonds with call options attached that allow the issuer to buy back the bond early; floating-rate notes that have fluctuating interest payments adjusted to an interest rate benchmark; and convertible bonds that offer the bondholder the option to convert to equity in the issuer if certain conditions are met.

In addition, there are different seniorities of bonds. The most senior may be secured against certain assets of a company while more junior or subordinated bonds rank lower down the capital structure in terms of repayment if the issuing company gets into difficulty, although all bonds typically rank above equity. When investing in high-yield bonds, therefore, it can be useful to look at the capital structure and different types to determine what type of bond might offer the best value.

Risk considerations

High-yield bond holders rank above equity holders in the capital structure and therefore have a superior claim on the company’s assets. High-yield bonds are, however, issued by companies where there is a higher risk of default. The main risks facing high-yield bonds include:

- **Idiosyncratic risk:** These are risks that are specific to the issuing company, such as unexpected earnings results or news such as a change in management that can impact prospects for the company and its cashflow. This risk also extends to the industry within which the issuing company operates, such as structural change disrupting a sector.
- **Credit risk or default risk:** The risk that an issuer fails to meet its payment obligations – i.e., the coupon and/or the final maturity payment. In some cases, the bondholder may be able to recover unpaid coupons or the final maturity value of the bond, but in the worst-case scenario, an investor could lose the capital they invested in the bond.
- **Downgrade risk:** If a bond’s credit rating is lowered, this is likely to lead to a lower price for the bond as investors in the market perceive the bond as riskier and demand higher compensation to hold the bond.
- **Interest rate risk:** While high-yield bonds are typically less sensitive to rises in interest rates than investment-grade corporate bonds, they are not wholly immune to rate movements. A large rise in interest rates or government bond yields is likely to push up the yield on high-yield bonds (causing the price of existing high-yield bonds to fall). This risk is generally greater the longer the remaining time to maturity of a bond.
- **Liquidity risk:** The high-yield on high-yield bonds also seeks to compensate for possible illiquidity – difficulty in trading the security. During times of market stress, it may be difficult to find a buyer of a bond at an acceptable price, which could lead to a loss for the bondholder if they are a forced seller.

About the authors

Seth Meyer, CFA

Head of Fixed Income Strategy, Portfolio Manager

Seth Meyer is Head of Fixed Income Strategy at Janus Henderson Investors, a role he has held since 2022. In this role, Seth informs on the strategic direction and ESG strategy of the fixed income platform, and leads the client portfolio manager team. Additionally, he is a Portfolio Manager responsible for co-managing the U.S. and Global High-Yield, Multi-Sector Credit and Short Duration High-Yield strategies. Seth was promoted to assistant portfolio manager supporting primarily the High-Yield and Short Duration High-Yield strategies in 2012. He joined Janus in 2004 as a product manager covering a variety of equity and fixed income strategies before becoming a credit analyst. Prior to Janus, he was a consultant relations manager at OppenheimerFunds.

Seth received his bachelor of science degree in business administration with a concentration in finance from the University of Colorado. He holds the Chartered Financial Analyst designation and has 24 years of financial industry experience.

Brent Olson

Portfolio Manager

Brent Olson is a Portfolio Manager at Janus Henderson Investors, a role he has held since 2019. Brent rejoined Janus Henderson in 2017 as a credit analyst. He co-manages the U.S. High-Yield, Short Duration High Yield and Global High Yield strategies. Prior to this, he was a lead portfolio manager at Scout Investments on a growth equity strategy that emphasized fixed income metrics and credit data points to select stocks. Before Scout, he oversaw high-yield and leveraged equity research as well as managed fixed income products at Three Peaks Capital Management from 2005 until 2013. From 2000 until 2004, Brent was an investment analyst at Invesco Funds Group. He started his financial career in 1997 as a credit analyst with Janus until 2000.

Brent received his bachelor of arts degree in anthropology from the University of Virginia. He earned his MBA with a concentration in finance from the University of Colorado and has 25 years of financial industry experience.

FOR MORE INFORMATION, PLEASE VISIT **JANUSHENDERSON.COM**

Janus Henderson
INVESTORS

The opinions and views expressed are as of the date published and are subject to change. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. No forecasts can be guaranteed. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent and may not reflect the views of others in the organization. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. Janus Henderson Group plc through its subsidiaries may manage investment products with a financial interest in securities mentioned herein and any comments should not be construed as a reflection on the past or future profitability. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. **Past performance does not predict future returns. Investing involves risk, including the possible loss of principal and fluctuation of value.**

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

Bond prices generally move in the opposite direction of interest rates, thus bond prices may decline as interest rates rise, and vice versa.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

Environmental, Social and Governance (ESG) or sustainable investing considers factors beyond traditional financial analysis. This may limit available investments and cause performance and exposures to differ from, and potentially be more concentrated in certain areas than, the broader market.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Janus Henderson is a trademark of Janus Henderson Group plc or one of its subsidiaries. © Janus Henderson Group plc.

C-1022-45817 10-15-23

688-10-445817 10-22