Janus Henderson INVESTORS

THE CASE FOR HIGH YIELD BONDS

What is a high yield bond?

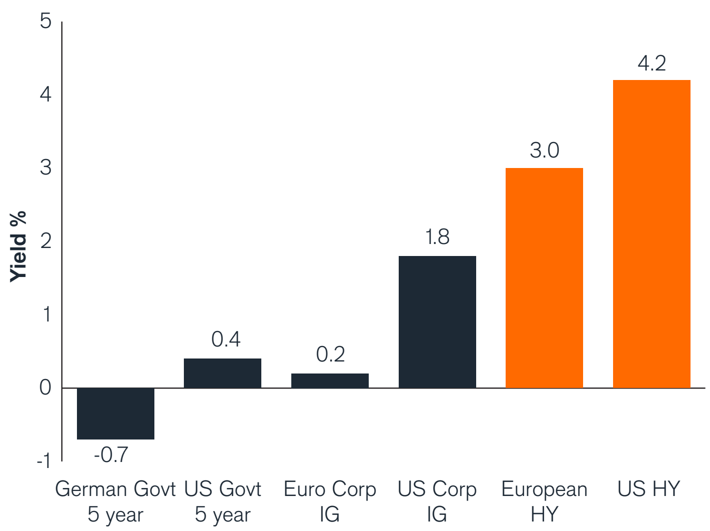
Companies issue corporate bonds to raise funds, promising to pay the investor interest (the coupon) each year and repay the par value of the bond when the bond matures. High yield bonds are corporate bonds that carry a sub-investment grade credit rating. This means they are rated equal to or lower than 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 US more than 40 years ago. Today, the global high yield market comprises a vast range of issuing companies, from household giants such as Jaguar Land Rover, Netflix and Banco do Brasil, through to small and medium-sized companies that are raising funding via the bond markets for the first time. This creates a diverse mix of issuers that can reward strong credit analysis.

An attractive source of income

Trying to achieve an attractive yield on investments has become a challenge as central banks have driven interest rates lower. This has been compounded by unconventional policy measures such as central bank asset purchase schemes (quantitative easing), which involves creating money to purchase government and corporate bonds to keep financing costs low. As Figure 1 shows, high yield bonds offer a strong yield pick-up compared with other forms of debt.

Figure 1: Yields on different types of fixed income



Key takeaways:

- High yield corporate bonds have historically offered an attractive source of yield, which in turn has contributed to competitive total returns.
- Occupying the centre 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.
- Given the high degree of idiosyncratic risk in high yield bonds, it is an asset class that can reward good security selection.

Source: Bloomberg, govt = government, Generic German 5-Year Government Bond (GDBR5), Generic US 5-Year Government Bond (USGG5YR); ICE BofA Indices, Euro Corporate IG (investment grade) = ER00, US Corporate IG = C0A0, European HY (high yield) = HP00, US HY = H0A0. Yield to maturity for government bonds, yield to worst for corporate bonds, as at 31 December 2020. Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

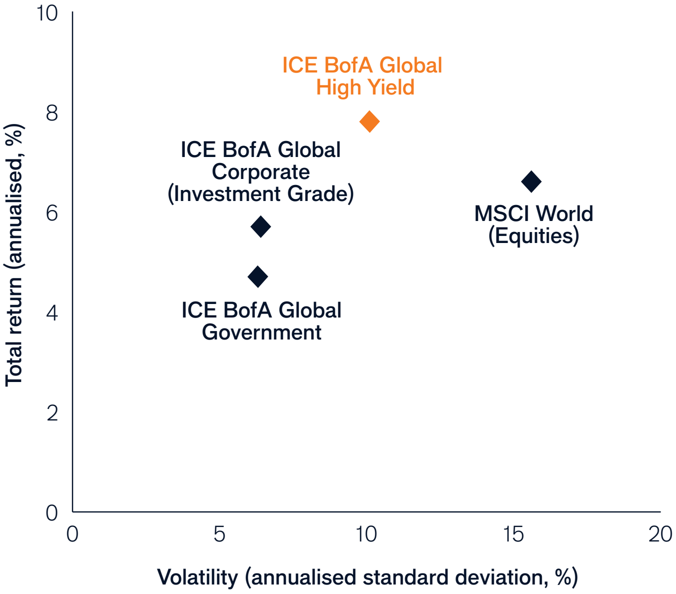
Yields may vary and are not guaranteed.

Any securities, funds, sectors and indices mentioned within this document do not constitute or form part of any offer or solicitation to buy or sell them.

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, global high yield bonds have outperformed government bonds, investment grade corporate bonds, and equities, with much less 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 return.

Figure 2: Total return versus volatility, 2000 to 2020

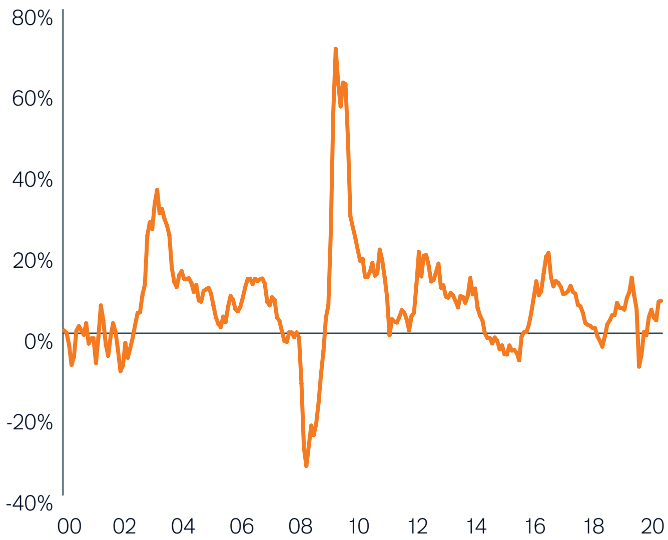


Source: Refinitiv Datastream, total return indices in US dollars, 31 December 2000 to 31 December 2020. Volatility is standard deviation, using monthly data returns.

Past performance is not a guide to future performance.

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. By holding a diverse portfolio of high yield bonds, this can help an investor to 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: ICE BofA Global High Yield Bond Index, 12-month rolling returns



Source: Refinitiv Datastream. Monthly rolling 12-month total returns, in US dollars, 31 December 2000 to 31 December 2020.

[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.

Past performance is not a guide to future performance.

Low sensitivity to the interest rate cycle

High yield bonds are typically less sensitive to rises in interest rates or inflation because the spread (additional yield over equivalent government bond) 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 typically have lower duration (sensitivity to interest rates) than other types of fixed income.

Figure 4: Duration within fixed income

	Duration (years)
European high yield	3.5
US high yield	3.7
European investment grade	5.4
US government	7.5
US investment grade	8.5
European government	8.8

Source: Bloomberg, Refinitiv Datastream, indices as per Figure 1, European govt = ICE BofA European Union Government Index, US govt = ICE BofA US Treasury Index, effective duration, all maturities indices, as at 31 December 2020.

As the correlation table below demonstrates, high yield has had a low correlation with government bond markets, offering the potential as a diversifier within a fixed income portfolio.

Figure 5: Correlation of asset classes (2000 to 2020)

	Global HY	Global IG	Global govt	Global equities
Global high yield (HY)	1.00			
Global investment grade (IG)	0.68	1.00		
Global government	0.21	0.76	1.00	
Global equities	0.76	0.51	0.11	1.00

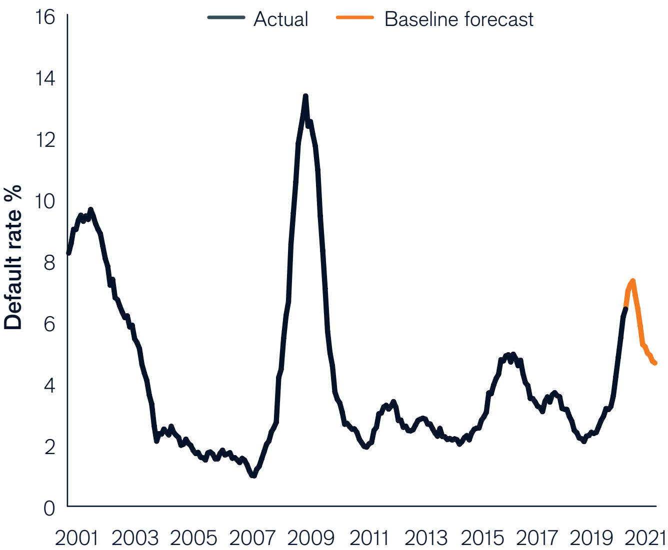
Source: Refinitiv Datastream, indices as per Figure 2, correlation coefficients of monthly total returns in US dollars, 31 December 2000 to 31 December 2020.

Default rates and credit ratings

For a long-term investor, the heightened risk of default is the key driver of spreads for high yield bonds. While the COVID-19 coronavirus crisis did cause a rise in global high yield default rates, the massive support measures by central banks and fiscal stimulus by governments meant the default rate ended up being lower than it could have been given the scale of the economic downturn. In 2020, globally, the oil and gas sector had the highest number of defaults, followed by business services and the retail sector.[2] These sectors are likely to face ongoing challenges in 2021 as the structural headwinds of disruption combine with the cost of economic lockdowns, although there may be opportunities to benefit from recovery. A selective approach to investment with a focus on rigorous fundamental research can help in avoiding defaults and in seeking to generate outperformance.

[2] Source: Moody's December 2020 Default Report, 11 January 2021.

Figure 6: Global speculative grade default rate, trailing 12 months



Source: Moody's Default Report, 31 December 2001 to 31 December 2020. Moody's forecast at 14 January 2021 for the year to 31 December 2021. The forecast is an estimate only and is not guaranteed.

It could be argued that the coronavirus crisis and the policy responses, including nascent vaccination programmes, truncated the normal credit cycle, bringing forward the downturn (recession) phase to 2020 and the subsequent recovery phase. Prior to 2020 high yield bond issuers had typically been using proceeds of issuance for refinancing rather than more aggressive and less bondholder-friendly activities such as share buy-backs and leveraged buyouts. Leverage (net debt as a proportion of earnings) rose in 2020 as companies were forced to borrow to make up for revenue shortfalls, climbing from 3.5 times earnings in Q3 2019 to 4.5 times in Q3 2020.[3] Provided vaccination programmes are successful, a return to more normal economic conditions should allow companies to restore earnings and cash flows and begin to reduce leverage levels.

The crossover space between investment grade and high yield can be a source of returns as mispricing often exists in this area. COVID-19 economic disruption has led to changes in credit ratings and investors should expect further movement in 2021, both downgrades and upgrades. One of the first ratings moves in 2021 was the upgrade of Fiat Chrysler into investment grade, hitherto one of the larger high yield borrowers.

Investment grade bonds downgraded into the high yield space (so-called 'fallen angels') can provide attractive risk-return opportunities if carefully selected. Provided there is not a deluge – which could lead to credit spread widening – downgrades can also add valuable diversity.

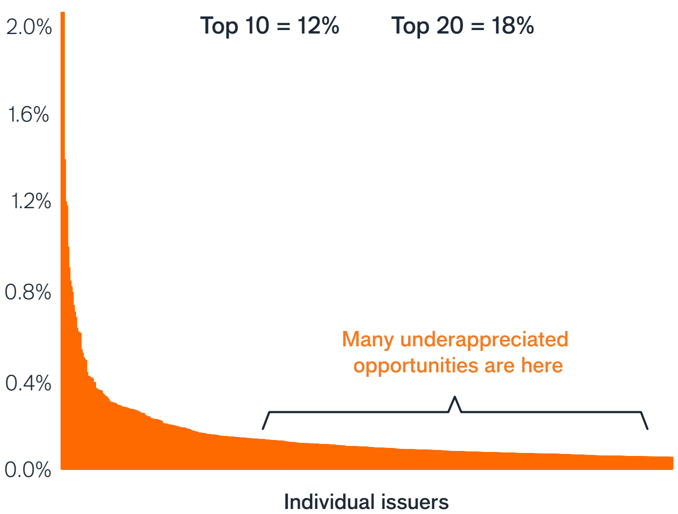
[3] Source: Morgan Stanley, European Credit Strategy, 18 January 2020. Net leverage = Net debt/(earnings before interest, tax, depreciation and amortisation).

Significant 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 global high yield



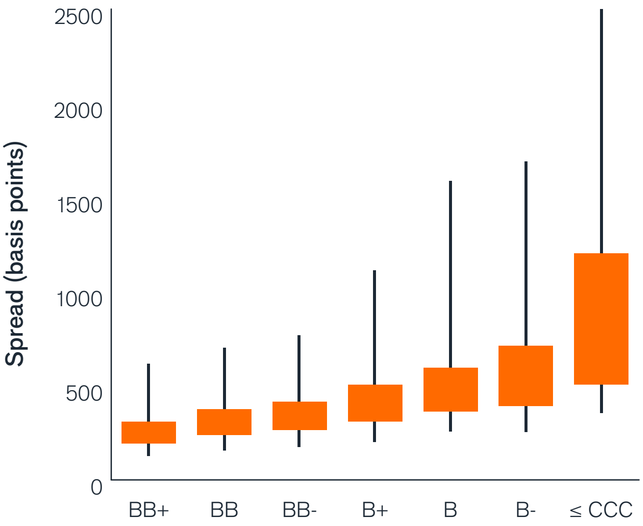
Source: Bloomberg, ICE BofA Global High Yield Constrained Index (HW0C), as at 31 December 2020.

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 US-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 companies on the right side of change and, therefore, in a stronger position to remain commercially relevant and to be 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: ICE BofA Global High Yield Bond Index, as at 31 December 2020. The chart shows the interquartile range (orange box) and 5th/95th percentiles by rating category (grey line).

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, these 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.
- **Default risk:** the risk that an issuer fails to meet its payment obligations – 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 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.

Accessing the asset class

Want to know more? For information about the high yield strategies that Janus Henderson manages, please visit our website or use the contact details below.

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested.

Contact us

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

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