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 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.

A reference guide to credit ratings

	Moody's	S&P	Fitch	Definition
Investment grade	Aaa	AAA	AAA	Highest quality
	Aa1	AA+	AA+	
	Aa2	AA	AA	Very high credit quality
	Aa3	AA-	AA-	
	A1	A+	A+	
	A2	A	A	High credit quality
	A3	A-	A-	
	Baa1	BBB+	BBB+	
	Baa2	BBB	BBB	Good credit quality, adequate capacity to meet financial commitments
	Baa3	BBB-	BBB-	
Sub-investment grade (high yield)	Ba1	BB+	BB+	
	Ba2	BB	BB	Speculative grade, less vulnerable in the near term but faces uncertainties
	Ba3	BB-	BB-	
	B1	B+	B+	
	B2	B	B	Highly speculative, more vulnerable to adverse business conditions but currently has capacity to meet financial commitments
	B3	B-	B-	
	Caa1	CCC+	CCC+	
	Caa2	CCC	CCC	Substantial credit risk, low margin of safety and dependent on favourable business and economic conditions
	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, aggregated definitions are a concise interpretation of the definitions from the credit rating agencies but are not those of a specific agency per se, as at 31 July 2022. Credit ratings can vary over time and are not a guarantee of an outcome for a bond.

What is a high yield bond?

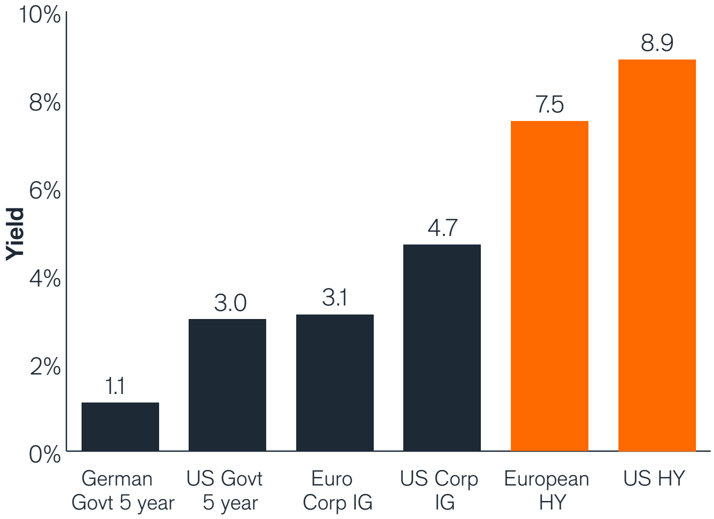
Companies issue corporate bonds to raise funds, promising to pay the investor interest (the coupon) each year and repay the par value of the bond when the bond matures. High yield bonds are corporate bonds that carry a sub-investment grade credit rating. This means they are rated equal to or lower than 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 US more than 40 years ago. Today, the US$2 trillion global high yield market comprises a vast range of issuing companies, from large enterprises such as Twitter, Marks & Spencer and Pemex (Petróleos Mexicanos), 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

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 this, high yield bonds have continued to offer an attractive source of yield, outpacing other forms of debt, as Figure 1 demonstrates.

Figure 1: Yields on different types of fixed income



Source for high yield market size and example constituents: Bloomberg, ICE BofA Global High Yield Index, full market value in US dollars, as at 30 June 2022. Constituents may vary over time.

Source for chart: Bloomberg, govt = government, Generic German 5-Year Government Bond (GTDEM5Y), 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 30 June 2022. 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.

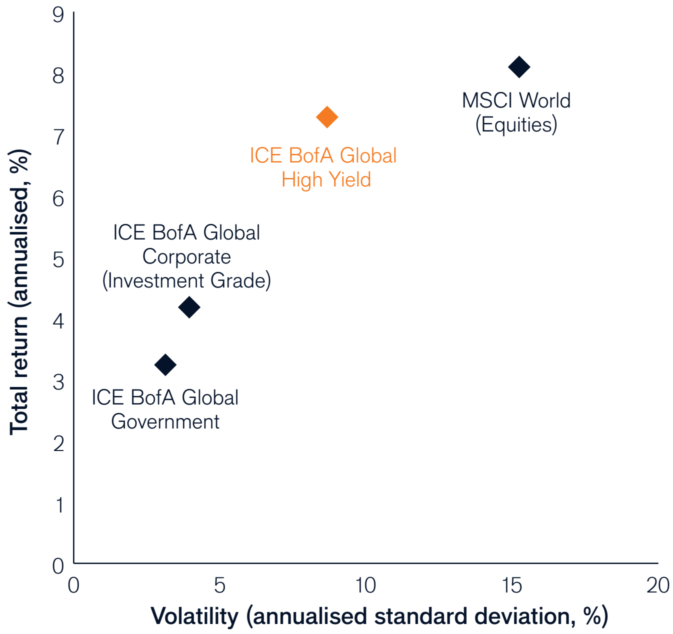
Yields may vary and are not guaranteed.

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 bond and investment grade corporate bonds, and are not far behind equities, albeit 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 (June 2002 to June 2022)

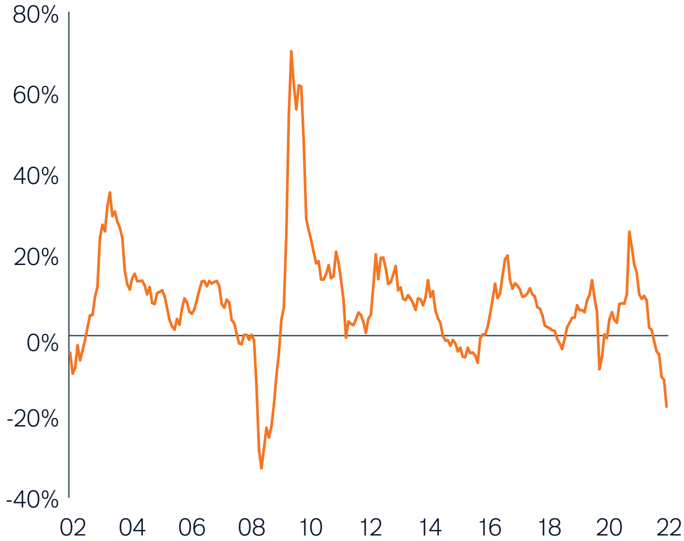


Source: Morningstar. © Morningstar, all rights reserved. Total return indices, in US dollars, bond indices hedged to US dollars, 30 June 2002 to 30 June 2022. Volatility is standard deviation, using monthly data returns.

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. 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: Bloomberg. Monthly rolling 12-month total returns, in US dollars, 30 June 2002 to 30 June 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)
European high yield	3.4
US high yield	4.5
European investment grade	4.9
US government	6.7
US investment grade	7.3
European government	7.7

Source: Bloomberg, 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 30 June 2022.

[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 government bond markets, offering the potential as a diversifier within a fixed income portfolio.

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

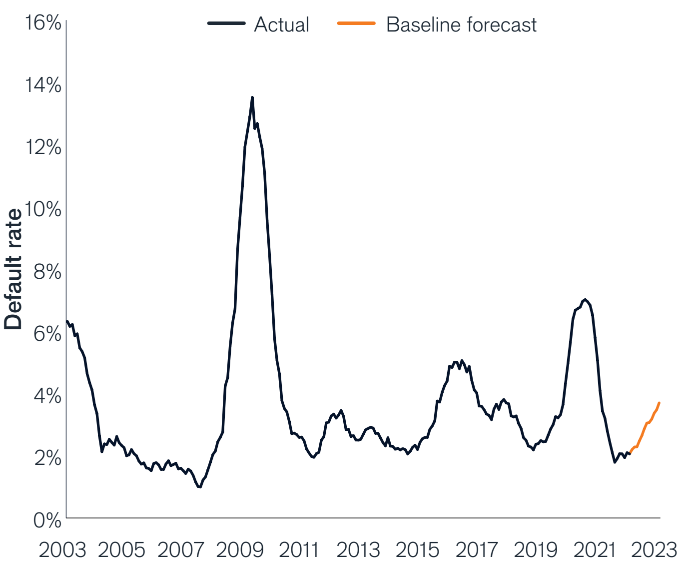
	Global HY	Global IG	Global govt	Global equities
Global high yield (HY)	1.00			
Global investment grade (IG)	0.74	1.00		
Global government	0.30	0.78	1.00	
Global equities	0.78	0.58	0.19	1.00

Source: Bloomberg, indices as per Figure 2, correlation coefficients of monthly total returns in US dollars, 30 June 2002 to 30 June 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: Global speculative grade default rate, trailing 12 months



Source: Moody's Default Report, 30 June 2002 to 30 June 2023. Moody's forecast at 17 July 2022 for the year to 30 June 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 amongst 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. Large issuers that have made that move into investment grade in the past year include Netflix, Freeport-McMoRan and Kraft Heinz.

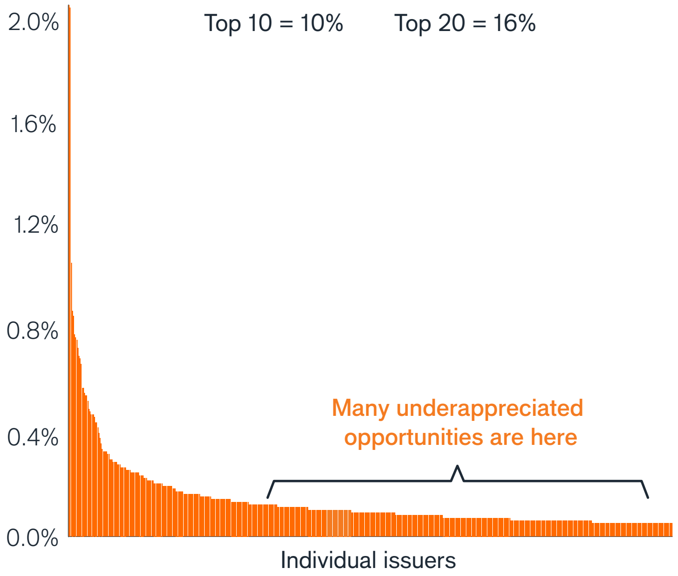
Significant opportunities for credit selection

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 30 June 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 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.

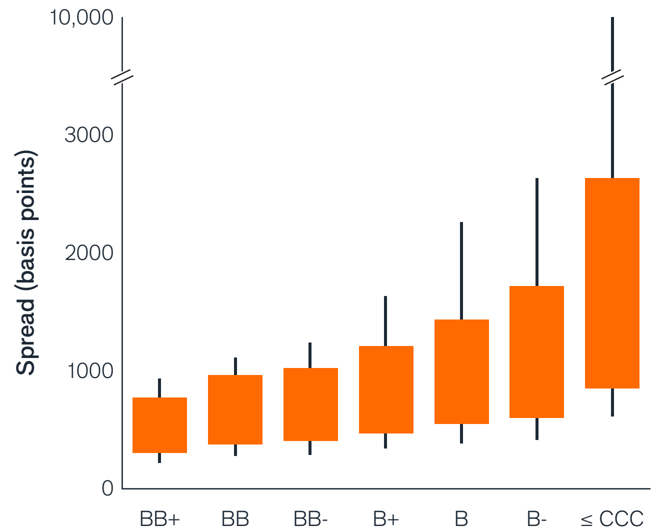
ESG factors

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 potentially 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 30 June 2022. The chart shows the interquartile range (orange box) and 5th/95th percentiles by rating category (grey 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, 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.
- **Credit risk or 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 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.

Accessing the asset class

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

Past performance does not predict future returns. 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.

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