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Investment Basics

High Yield Bond Basics

High yield bonds – defined as corporate bonds rated below BBB- or Baa3 by established credit rating agencies – can play an important role in many portfolios.

High yield bonds typically offer higher interest rates than government bonds or high grade corporates, and they have the potential for capital appreciation in the event of a rating upgrade, an economic upturn or improved performance at the issuing company. Also, because the high yield sector generally has a low correlation to other sectors of the fixed income market along with less sensitivity to interest rate risk, an allocation to high yield bonds may provide portfolio diversification benefits. In addition, high yield bond investments have typically and may continue to offer equity-like returns over the long term with less volatility.

What Makes a Bond High Yield?

Credit rating agencies evaluate bond issuers and assign ratings. Issuers are rated on their ability to pay interest and principal as scheduled. Those issuers considered having[?] a greater risk of defaulting on interest or principal payments are rated below investment grade (see Chart 1). These issuers must pay higher interest rates to attract investors to buy their bonds.

Chart 1. Bond credit quality ratings

CREDIT RISK	MOODY'S*	STANDARD & POOR'S**	FITCH**
Investment Grade			
Highest Quality	Aaa	AAA	AAA
High quality (Very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium	Baa	BBB	BBB
Below Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or basnkruptcy petition filed	C	C	C
In default	C	D	D

Source: Moody's, Standard & Poor's, Fitch

* The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2 or 3 to show relative standing within the category, e.g., Baa2

** The rating standings fro AA to CC by Standard & Poor's and Fitch may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the category, e.g., A-

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While agency credit ratings define the high yield market, and many investors rely on these ratings in their portfolio guidelines, investors may also conduct independent credit analysis of company fundamentals and other factors to form their own conclusions about a security's risk of default.

Who Issues High Yield Bonds?

Until the 1980s, high yield bonds were simply the outstanding bonds of "fallen angels" – former investment grade companies that had been downgraded below investment grade. Investment banks, led by Drexel Burnham Lambert, launched the modern high yield market in the 1980s by selling new bonds from companies with below-investment grade ratings, mainly to finance mergers and acquisitions or leveraged buyouts.

The high yield market has since evolved, and today, much high yield debt is used for general corporate purposes, such as financing capital needs or consolidating and paying down bank lines of credit. Mainly focused in the U.S. through the 1980s and 1990s, the high yield sector has since grown significantly around the globe in terms of issuance, outstanding securities and investor interest.

New high yield issuance can vary greatly from year to year depending on economic and market conditions, typically expanding along with economic growth, when investors' appetite for risk often increases, and waning in recessions or market environments when investors are more cautious.

The high yield sector includes both originally-issued high yield bonds and the outstanding bonds of fallen angels, which can have a significant impact on the overall size of the market if large or numerous companies are downgraded to high yield status. Conversely, the sector can shrink when companies are upgraded out of the speculative grade market into the investment grade sector.

Considering a High Yield Bond Investment?

High yield bonds may offer investors a number of potential benefits, coupled with specific risks. Investors can endeavor to manage the risks in high yield bonds by diversifying their holdings across issuers, industries and regions, and by carefully monitoring each issuer's financial health.

Diversification. High yield bonds typically have a low correlation to investment grade fixed income sectors, such as Treasuries and highly rated corporate debt, which means that adding high yield securities to a broad fixed income portfolio may enhance portfolio diversification. [It's important to note/remember that] Diversification does not insure against loss, but it may help decrease overall portfolio risk and improve the consistency of returns.

Enhanced current income. To encourage investment, high yield bonds usually offer significantly greater yields than government bonds and many investment grade corporate bonds. Average yields in the sector vary depending on the economic climate, generally rising during downturns when default risk also rises (high yield companies may be more negatively affected by adverse market conditions than investment grade companies). For example, for much of the 1980s and 1990s, U.S. high yield bonds typically offered 300 to 400 basis points of additional yield relative to U.S. Treasury securities of comparable maturity, according to the Securities Industry and Financial Markets Association. But following the credit crisis in 2007–2008, the spread between high yield and government bonds was much greater.

Capital appreciation. An economic upturn or improved performance at the issuing company can have a significant impact on the price of a high yield bond. This capital appreciation is an important component of a total return investment approach. Events that can push up the price of a bond include ratings upgrades, improved earnings reports, mergers or acquisitions, management changes, positive product developments or market-related events. Of course, if an issuer's financial health deteriorates, rating agencies may downgrade the bonds, which can reduce their value.

Equity-like long-term return potential. High yield bonds and equities tend to respond in a similar way to the overall market environment, which can lead to similar return profiles over a full market cycle. However, returns on high yield bonds tend to be less volatile because the income component of the return is typically larger, providing an added measure of stability. In addition, the combination of enhanced yield and the potential for capital appreciation (though less than for equities) means that high yield bonds can offer equity-like total returns over the long term. Also, bondholders have priority over stockholders in a company's capital structure in the event of bankruptcy or liquidation; high yield bond investors therefore have a greater chance of recovering a greater portion of their investment than equity investors.

Relatively low duration. Low duration, or sensitivity to changes in interest rates, tends to lower volatility. One reason high yield bonds often have relatively low duration is that they tend to have shorter maturities; they are typically issued with terms of 10 years or less and are often callable after four or five years. Generally, high yield bond prices are much more sensitive to the economic outlook and corporate earnings than to day-to-day fluctuations in interest rates. In a rising rate environment, as would be expected in the recovery phase of the economic cycle, high yield bonds would be expected to outperform many other fixed income classes. That said, the high yield sector does not demand great economic times; most issuers may function very well and continue to reliably service their debt in a low growth environment.

Conclusion

High yield bonds can play an important role in a portfolio, enhancing return potential while improving diversification, particularly due to their low correlation to investment grade fixed income securities. High yield bonds can be similar to equities in that they tend to be heavily influenced by developments in the corporate sector, but the income provided by high yield bonds and their senior placement in the capital structure help to make these securities less risky than stocks. From a portfolio perspective, high yield investments fit into the space between equity and fixed income.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

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