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MARKET WISDOM

Don't overlook high-yield bonds, they could turn out to be...

HIDDEN TREASURE

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HIGH-YIELD BONDS, OFTEN referred to as "junk bonds", always seem to evoke a negative connotation that scares away many potential investors. But adding these bonds to your portfolio can build returns and yield, without increasing volatility.

Simply put, high-yield bonds are debt issues rated "below investment grade" by one or more of the established credit rating agencies. Typical investment-grade debt ratings range from AAA to BBB.

Below investment grade? Junk? Casual observers, using only these labels as their guide, may understandably choose to invest elsewhere.

At CIBC, however, we like to look beyond labels when making our investment decisions, and in this article I will address some misperceptions about high-yield bonds.

I'll take a look at how an investor, holding a diversified portfolio of equities, may already be exposed to a high-yield issuer's balance sheet and has, therefore, implicitly accepted the business case behind high-yield companies.

In addition, I'll examine relative value of high-yield bonds, and show how they can offer a yield premium with only a marginal increase in credit risk but a lower level of interest rate risk.

In short, I believe that high-yield bonds, which are often misperceived as "junk", can actually be a "treasure" as a component of an overall fixed income portfolio.

Burdened with their negative labels, high-yield bonds are often perceived as low quality and high risk.

Many investors are reluctant to consider this asset class as part of their portfolio, fearing that holding these bonds means holding companies that are highly leveraged and are likely to default on their borrowing obligations.

These investors may be surprised to learn that many of the companies whose bonds are rated below investment grade are, in fact, well-established and well-known businesses that have been operating profitably for many decades.

Notable examples include Bombardier and Mattamy Homes in Canada, as well as iconic U.S. brands such Hertz, MGM Resorts, Neiman Marcus and Goodyear.

Investors may not realize that they could already have "below investment grade" names within their equity holdings.

The table below looks at the credit ratings of companies whose equity is listed in the S&P/TSX Composite Index and the S&P 500 Index.

As of the second quarter 2013, 14 per cent of the companies listed in both the TSX and S&P indices are rated non-investment grade. Another 14 per cent are just one notch away from high yield status, rated BBB.

With high-yield issuers holding

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significant weightings in these two major equity indices, a well-diversified large-cap investor is likely holding equity of high-yield issuers.

If an investor is willing to invest in the equity of these issuers, why is the same investor reluctant to lend money to the same company?

These bonds are actually a higher-quality investment because they are higher in the capital structure. This observation reveals a misperception in the minds of some investors. Theoretically, the entire amount of invested equity should be wiped out before a high yield bond loses $1 in principal.

Faulty mental accounting describes the relative risks between high-yield bonds and equity of the same issuers.

But investors may also be concerned about the absolute levels of risk. How often do issuers default?

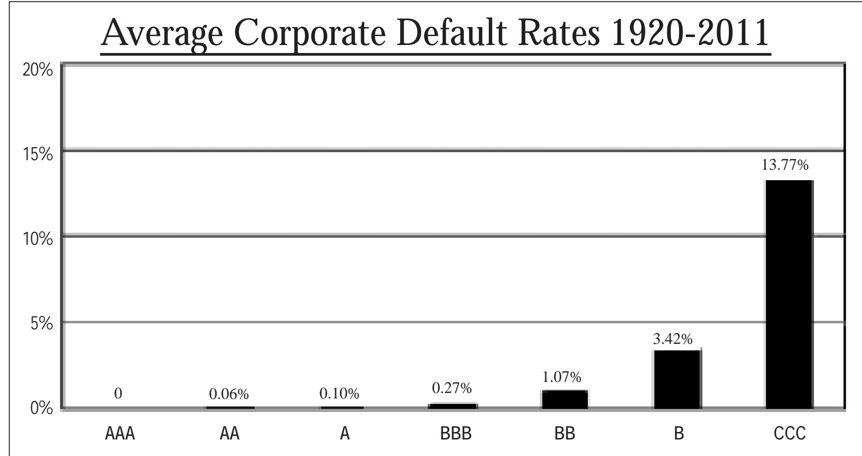
As it turns out, only a small percentage of bonds rated as "below investment grade" actually default. In fact, the difference in default rates between the lowest-rated, investment-grade bonds (BBB) and the highest-rated, non-investment-grade rated bonds (BB) is less than one per cent.

In the current low-yield environment, institutional and retail investors have looked more closely at high-yield bonds because of their higher income stream.

Many of these investors have seen through the misperceptions and increased their exposure to this asset class. As a result, the size of the high-yield bond market has grown tremendously in both Canada and the U.S. over the last five years.

The high-yield market in Canada grew from $1.9 billion to $13.1 billion – and from $458.7 billion to $1,217.7 billion in the U.S. – between 2008 and 2013. The growth over this period was fuelled primarily by market appreciation in 2009 and the significant increase in investor demand.

Today, high-yield bonds make up 20 per cent of the overall North American corporate bond market.



High-yield bonds in perspective

High-yield companies (June 2013)

	S&P/TSX Composite	S&P 500 Index
Investment Grade Issuers (%)	33	72
High-yield Issuers (%)	14	14
Non-rated Issuers (%)	53	14

Source: Bloomberg L.P.

MISSED OPPORTUNITIES

We believe that investors limiting themselves to investment-grade bonds unnecessarily constrain their ability to capture diversification benefits.

From an equity perspective, excluding high-yield names from the overall equity allocation reduces the universe to only 33 per cent of all debt issuers in Canada and 72 per cent of all debt issuers in the United States.

The U.S. high-yield bond market is much larger and far more diversified that the Canadian corporate bond market. By including high-yield bonds, investors can capture greater diversification benefits by expanding their portfolios.

The U.S. high-yield market is valued at $1.25 trillion, which is over three times larger than the entire Canadian corporate bond market in terms of both size and number of issuers.

Important: it is common for institutional investment policies to prohibit high-yield bonds; this creates a structural market inefficiency.

Many institutions are forced to sell a bond once its rating drops below investment grade, or they

are restricted from buying a bond on the cusp of being upgraded to investment grade status.

These inefficiencies provide high-yield portfolio managers the opportunity to capture additional alpha for investors' portfolios.

This permanent market inefficiency is particularly evident at the "crossover area" on the credit curve. This is where high yield and investment grade are only one rating away from each other (BBB versus BB).

Another advantage is that high-yield managers can pick up incremental yield (in the range of 110 to 170 basis points in 2013), with only a marginal increase in financial risk (leverage). At the same time the difference in default rate at the crossover area is only minor.

Finally, in the current environment of historically low yields, high-yield bonds are less sensitive to rising interest rates. For example, BB bonds have a lower duration (4.8 years compared to 6.7 for BBBs) and the higher coupon provides significant cushion against rising rates.

At CIBC, we view this area as a sweet spot and a key focus area in our high-yield portfolios. Our investment-grade bond portfolios are also positioned to take advantage of this inefficiency.

THE BOTTOM LINE

I believe that many investors, misled by the term "junk" are missing out on a tremendous opportunity.

Not only does adding high-yield names to a corporate bond portfolio increase returns and yield, it does so without the expected incremental increase in return volatility.

Also, adding high-yield bonds provides diversification benefits due to their low correlations with other fixed income holdings. With all of these factors in mind, the term "junk bonds" seems inappropriate.

Instead, high-yield bonds might be considered a "treasure" that investors could add to their fixed income holdings. ▼

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