High-Yield Spreads and Time Walk Hand in Hand

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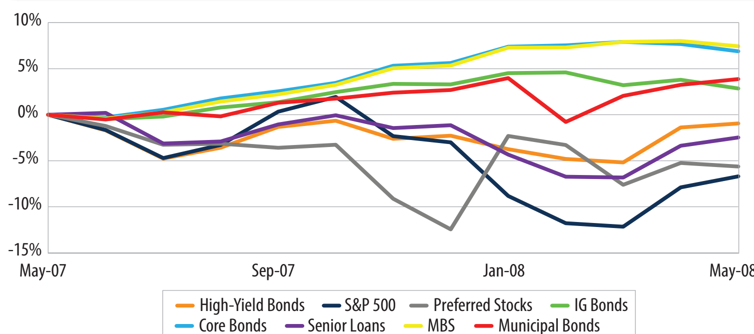
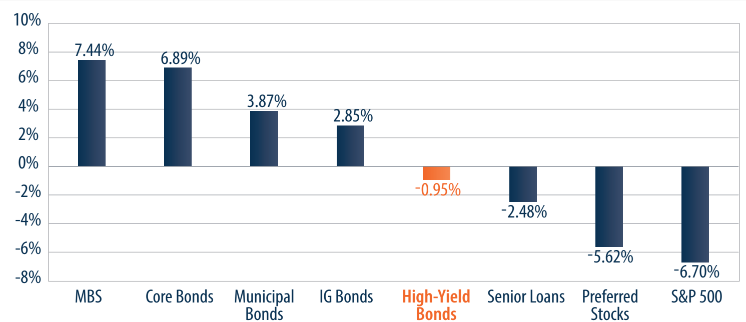
One of the most common metrics evaluated in the high-yield bond market is "spread." Spread is the difference in yield between a high-yield bond and a risk free U.S. Treasury bond of a comparable maturity/duration. Simply stated, the spread is the extra compensation an investor requires to bear the additional risk of an asset relative to the risk-free asset. Numerous research papers have demonstrated the benefits of investing in high-yield bonds when spreads are wide of their historical average. We agree that owning high-yield bonds when spreads are "wide" typically creates an attractive entry point into the asset class. However, as counterintuitive as it may seem, owning high-yield bonds when spreads are "tight" to the historical norm has also created attractive entry points into the high-yield asset class. The primary reason is that spread alone is not the only factor to consider. Investors need to consider that spread and time walk hand in hand, and using spread as a way to time an investment in high yield may miss the mark.

Let's consider the most extreme example, an investor who invested in high-yield bonds in May 2007 when spreads had reached their tightest (lowest) level in the history of the high-yield market. Moreover, the global financial crisis and financial market meltdown were just around the corner. Conventional wisdom would have suggested that this investor had pinpointed exactly the worst possible time to enter the high-yield market. But let's look forward and see what happened. Over the next 12 months, our investor would have lost a total of 0.95%. (SPX -6.70%). During that time, the high-yield market suffered a short term drawdown but had recovered most of the loss within 12 months *(Exhibit 1)*. Fast forward to May of 2010, a 3-year investment horizon, our investor would have earned a cumulative return of 18.01%. For comparison, the S&P 500 Index cumulative return was -23.88% over the same 3-year period *(Exhibit 2)*. Fast forward to a 5- and 10-year investment horizon and the results are even more compelling. Over a 5-year period, our investor would have generated a 43.83% cumulative total return, beating every major fixed-income asset class and the S&P 500 Index (SPX return -4.52%) *(Exhibit 3)* and over 10 years, the results were even more impressive with the high-yield total return of 104.85%, again, beating every major fixed income asset class and the S&P 500 Index (SPX return 95.54%). Importantly, over the 10-year period in our example the high-yield market exhibited nearly 1/3 less volatility than the S&P 500 *(Exhibit 4)*. Of course, past performance is certainly no guarantee of future results, however, as this example demonstrates, investing in high-yield bonds, even at tight spreads, can produce compelling returns for investors particularly over an intermediate/longer term time horizon.

Today, spreads within the high-yield bond market are indeed tighter than their historical average. Conventional wisdom in the market suggests that owning high-yield bonds while spreads are tighter than normal results in a negative outcome. We believe that spreads and time walk hand-in-hand. Over time, bonds, assuming they do not default, get repaid at par.[1] Moreover, as bonds mature, new bonds are typically issued to refinance the existing bonds at the then available market-rate. As such, maintaining an appropriate investment horizon tends to address the short-term market swings associated with spreads. Empirically, credit risk is a far more important variable when assessing the high-yield market. When corporate defaults begin to accelerate, losses (impairment of principal) become prevalent. Defaults are very low today, and are an important reason why spreads are inside of the long-term average. We believe corporations are on sound footing and defaults are likely to remain below the long-term average for some time. As such, we continue to believe that the high-yield bond asset class may offer attractive return opportunities in the periods ahead.

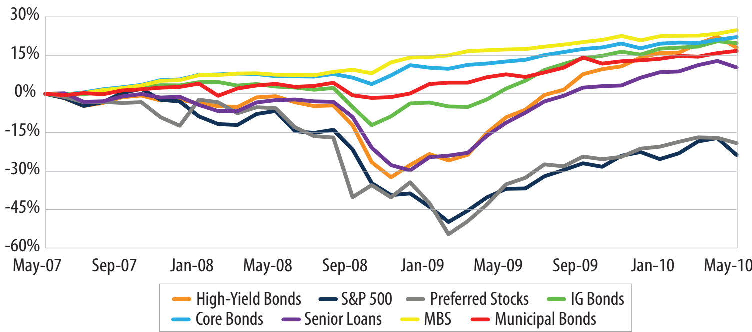
***Exhibit 1:* 1-Year Total Returns** (5/31/2007 - 5/31/2008)





[1] The face value of a bond. Par value for a bond is typically $1,000 or $100.
Source for all charts: Bloomberg.

***Exhibit 2:* 3-Year Total Returns** (5/31/2007 - 5/31/2010)



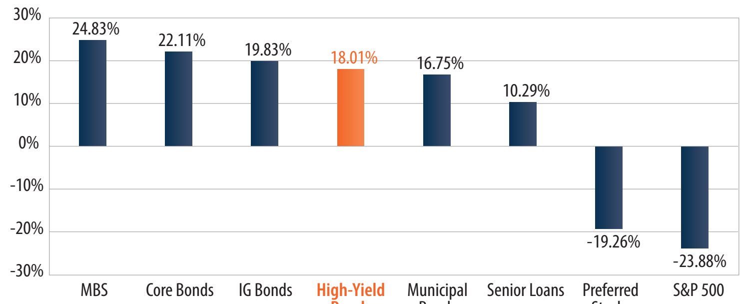
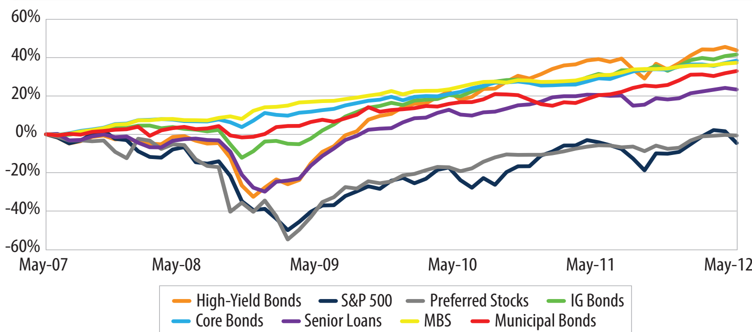


***Exhibit 3:* 5-Year Total Returns** (5/31/2007 - 5/31/2012)



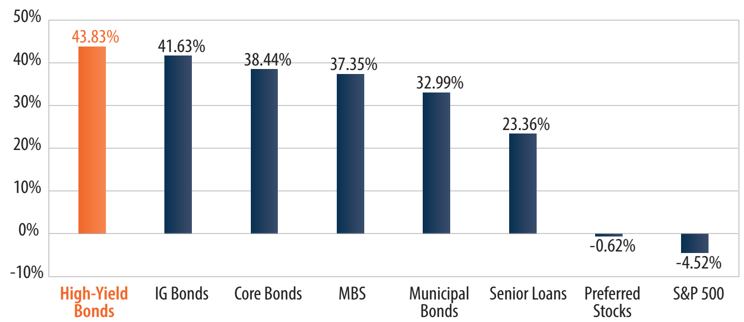
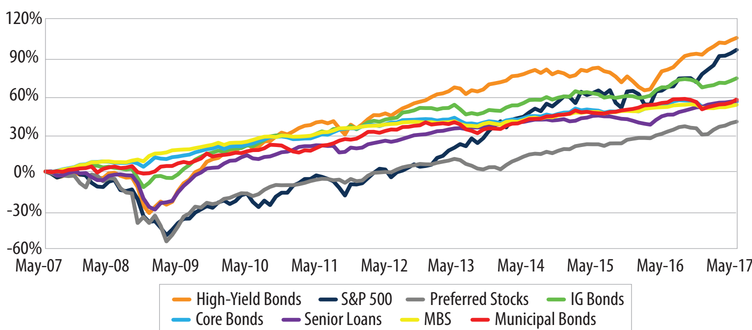
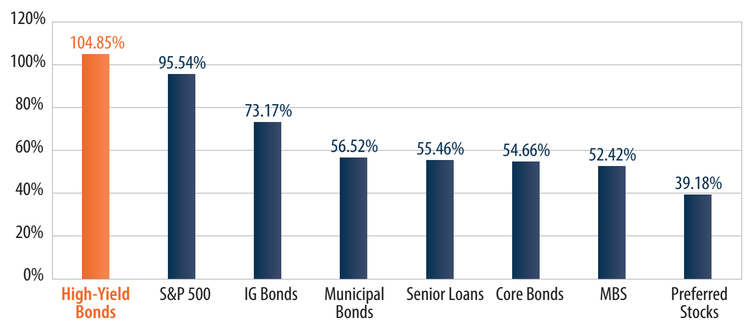


***Exhibit 4:* 10-Year Total Returns** (5/31/2007 - 5/31/2017)





Source for all charts: Bloomberg.

Index Definitions:

High-Yield Bonds–BofA Merrill Lynch U.S. High Yield Constrained Index (HUC0) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market but caps issuer exposure at 2%.

S&P 500–S&P 500 Index is a capitalization-weighted index comprised of 500 stocks used to measure large-cap U.S. stock market performance.

Preferred Securities (Preferred Stocks)–BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market.

Investment Grade Corporate Bonds (IG Bonds)–BofA Merrill Lynch U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade (BBB/Baa-rated or better) corporate debt publicly issued in the U.S. domestic market.

U.S. Core Bonds (Core Bonds)– U.S. Core Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index

Senior Loans–S&P/LSTA Leveraged Loan Index (LLI) is designed to track the current outstanding balance and spread over LIBOR for fully funded term loans.

Mortgage-Backed Securities (MBS)– Mortgage Backed Securities are represented by the Bloomberg Barclays U.S. Mortgage-Backed Securities Index.

Municipal Bonds–Bloomberg Barclays Municipal Bond Index tracks the performance of the tax-exempt bond market.

Past performance is no guarantee of future results. Historical performance figures for the indices are for illustrative purposes only and not indicative of any actual investment. Indexes are unmanaged and an investor cannot invest directly in an index.

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