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The Case for a Strategic Allocation to High Yield

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- The high yield market has come a long way since its creation in the early 1970s, evolving from a tactical asset class to a significant component of investors' asset allocation.
- Dispelling the myths around the asset class is key to understanding the opportunity and value provided by high yield corporate credit.
- Understanding the nuances of the high yield market can provide investors with exposure to the asset class while potentially avoiding some of the pitfalls of benchmark construction and ETFs.

A Long Way from “Junk” Status

“Junk” bonds aren’t junk; they first emerged in the late 1970s, marketed by Bear Stearns and Drexel Burnham. These bonds were “riskier” than typical investment grade bonds, but had the potential to deliver higher risk-adjusted returns. The high yield market grew from \$10 billion in 1979 to \$189 billion over the next 10 years and helped to rescue and finance companies like Chrysler and Turner Broadcasting. Books like “Predator’s Ball” and personalities like Michael Milken captivated America with stories of “high yielding, low quality junk bonds.” After a significant slowdown in new issuance from 1989-90, fueled by politically-driven campaigns, the market rebounded dramatically in 1991. By 1998, the market grew to \$565 billion as mainstream investors recognized the value and diversity in the high yield market. The market has traditionally been considered a “bolt on” to a core fixed income portfolio or a satellite allocation to overall portfolio positioning. Tactical allocations to the asset class were the most common allocations pre-Financial Crisis. Since then, investors have increasingly made strategic allocations to high yield fixed income in the same vein as equities, investment grade fixed income or alternatives.

Dispelling the Myths

In the following section, we discuss three of the most common myths about the high yield market. Once these myths are dispelled, the appeal of high yield as a stand-alone asset class becomes clear.

Myth #1: High yield is too similar to equities

While high yield began as a relatively small asset class that was susceptible to market fluctuations driven by liquidity concerns and an undeserved stigma of small private issuers, it has matured into a \$1.2 trillion domestic asset class comprised of household names like Netflix, T-Mobile and United Airlines. While the high yield and equity markets are somewhat correlated (0.62 correlation over the past 30 years) and directionally similar, it is important to note that there are significant differences between the two asset classes. For this analysis, we will consider the twelve-year period ending July 2018. July 2006 provides a comparable starting point as high yield spreads, as measured by the ICE BofA ML High Yield Index, were at 345, nearly identical to levels seen in the Index at the end of July 2018 (346). Over the 12-year period ending July 2018, the ICE BofA ML High Yield Index returned 7.45%, while the S&P 500 Index returned 9.09%, and the Bloomberg Barclays U.S. Aggregate Index returned 4.08%. While the High Yield Index trailed the S&P 500 from a performance standpoint, it delivered its return with significantly less volatility. The equity markets delivered a 9.09% return with a standard deviation of 14.15, while the high yield market returned 7.45% with a standard deviation of 9.75.

To better understand the resilience of the high yield market relative to the equity market, we look at the max drawdown, or the maximum loss from a peak to trough of a portfolio before a new peak is attained. During the Financial Crisis, the high yield market, as measured by the ICE BofA ML High Yield Index, and the S&P 500 suffered historic losses. In 2008, the S&P 500 declined 37.00% while the High Yield Index declined 26.39%. The High Yield Index recovered quicker than the equity market in 2009, returning 57.51% compared to a 26.46% return for the S&P 500. Over the three-year period ending December 2009, the High Yield Index returned 5.81% while equities lost 5.59%. Intuitively this makes sense, as bonds are higher in the capital structure than equities and should be impaired less than equities and recover sooner.

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	Max Drawdown (MDD)	MDD Peak Date	MDD Valley Date	MDD Number of Months	MDD Recovery Date	MDD Recovery Number of Months*
ICE BofA ML High Yield Index	-33.23%	6/1/07	11/30/08	18	8/31/09	27
S&P 500 Index	-50.95%	11/1/07	2/28/09	16	3/31/12	53

*Recovery period measures time period from peak date to recovery date.

Source: Morningstar

Note: Despite concerns about the ICE BofA ML High Yield Index as a benchmark for active managers, we believe it serves as the best representation of the high yield market. We address these concerns in our paper published in January 2017 titled “[Debunking the High Yield Index and High Yield ETFs.](#)”

Myth #2: Timing is everything

Many investors believe it is possible to time the high yield market based solely on spread levels and yield. While hindsight provides the ability to perform this type of reallocation to perfection, it is difficult to get the timing right over multiple market cycles.

If we consider June 2014 through the end of 2016 as a “mini-cycle” in the high yield market, we can better understand the perils of market timing. As illustrated in the table below, having the perfect foresight to get out of the high yield market at the peak would have prevented a loss of 12.23% (utilizing the ICE BofA ML High Yield Index), but unless you knew when to get back into the market, an investor most likely would have also missed some, if not all, of the recovery from February 2016 to the end of 2016. Maintaining an allocation to high yield during this mini-cycle would have delivered a return of 8.70%.

However, if an investor followed the methodology of attempting to time the markets and sold after December 2016, they would have missed out on the performance since then, which is 8.77%, compared to 1.89% for the investment grade universe, as measured by the Bloomberg Barclays U.S. Aggregate Index.*

	6/30/14 – 2/11/16	2/12/16 – 12/31/16	6/30/14 – 12/31/16	12/31/16 – 7/31/18
Beginning Option Adjusted Spread	353	887	353	421
Ending Option Adjusted Spread	887	421	421	346
ICE BofA ML High Yield Index*	-12.23%	23.17%	8.70%	8.77%

*Returns listed in table and paragraph above are cumulative returns. Option Adjusted Spread is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

Myth #3: Default potential is priced accurately

Determining the compensation for risk is never an easy task. In the high yield market, events can skew the calculation of the impact of default risk beyond reasonable levels. Using the calculation below, we can determine the estimated default rate based on current and historic spread levels in the markets.

As of July 2018, utilizing the ICE BofA ML High Yield Index:

Actual Spread	Excess Spread**	Default Loss	Recovery Rate (40%)	Estimated Default Rate
346	- 300	= 46	/ (100% - 40%)	= 0.77%

**Excess spread is the liquidity/volatility/sentiment component of credit spreads. 300 bps is the 20-year monthly median of the difference between actual spreads and actual default loss. For bonds, this figure has ranged from -202 bps (November 1991) to 1,687 bps (November 2008) with a standard deviation of 225 bps. Source: JPMorgan, “2017 High Yield Annual Review,” p.11.

While the current estimated default rate of 0.77% is lower than the actual current default rate of 1.15%, both levels reflect strong underlying domestic equity valuations and earnings. The potential variance between the estimated default rate and the actual default rate is best illustrated by looking at periods of volatility in the market to truly understand the opportunity set created by mispricing of default risk.

	Spread	Excess Spread	Default Loss	Estimated Default Rate	Actual Default Rate	Default Rate Six Months Later
9/30/2001	1,018	300	718	11.97%	9.19%	14.53%
11/30/2008	1,988	300	1,688	28.13%	1.46%	12.02%
2/29/2016	775	300	475	7.92%	3.00%	5.38%

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September 2001

Following the terrorist attacks on New York City and Washington, D.C., the financial markets were in a tailspin. What had been a slight chance for a recession prior to the attacks became a “technical” recession, pushed over the edge by the unprecedented destruction and tragic loss. Defaults had been increasing since the beginning of the year as the market continued to suffer through the bursting of the Tech bubble, as well as the scandal surrounding Enron. While the overall market was experiencing a default rate over 9%, the Technology sector was experiencing roughly 53% default rates and Telecommunications default rates were just under 15%. Over the following months, spreads continued to widen and provide opportunity in other areas of the market that were cheapening from contagion.

November 2008

As the Financial Crisis took a firm hold on the markets, high yield spreads widened to historic levels. At the end of November, the high yield market was pricing in an estimated default rate of 28.1%, despite the actual default rate hovering just below 2%. Investors with strong research capabilities (and even stronger fortitude) could find opportunities in the market, providing liquidity for those managers forced to exit positions. The increase in spread levels in the high yield market was disconnected with the actual default risk and this was later proven true as six months later the default level, though higher than November 2008, was less than half of the estimated default rate that the markets were pricing earlier in the period.

February 2016

Spreads peaked in February 2016, after the market witnessed a precipitous drop in the price of crude oil from \$107.26 on June 20, 2014, to a low of \$26.21 on February 11, 2016. As the price of oil sank, the estimated default rate in the high yield Energy market climbed from below 1% in June 2014 to 28.07% in February 2016. However, it should be noted that the move higher in spreads impacted not only the Energy sector but other sectors as well. Financials priced in an estimated default rate of 9.17% despite not posting a number higher than 2% since the end of the Financial Crisis. Technology priced in a default rate of 8.28%, even though the sector had not experienced any defaults since August 2015 and never experienced defaults greater than 1% during the remainder of the year.

Achieving Exposure to the High Yield Market

If an investor believes in high yield as a stand-alone asset class, the question then becomes how should investors achieve exposure to this market?

Since the Financial Crisis, we have seen an explosion of assets into the high yield asset class. Most assets are concentrated in the hands of the largest managers, contributing to the overreliance on the most liquid parts of the market, especially when coupled with the growth in ETFs. In a capacity-constrained asset class, this evolution has created opportunities for managers who are willing to look different than the index.

Fortunately for investors, there are many different ways to generate excess returns in the high yield asset class. Active share is commonly discussed in the equity world, but most fixed income investors focus on risk mitigation. We believe portfolio decisions should come down to a fundamental understanding of what you own and why you own it. Emphasis should not be placed on whether an issue is in an index or how large the issue weight is in the index. If we can analyze a business, understand the risks of the company and the bond, and believe we are being more than adequately compensated for risk, we want to own the bond in a meaningful way. If these criteria are not met, we won't buy the bond. This common-sense approach to investing is surprisingly uncommon in the high yield market.

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Having a long-term temperament is critical when taking advantage of favorable investment opportunities. Managing a portfolio for the long term allows managers to fully exploit opportunities in the market, from overreactions to quarterly results, to fund flows, and countless other sources of short-term noise. It also allows managers to be forward thinking as opposed to backwards looking.

Maintaining capacity discipline is also critical for active managers looking to deliver strong returns. The high yield market shares similarities to small cap equities in terms of market size and liquidity. The best opportunities can often be uncovered in smaller credits that may not be investable for the largest participants. We believe maintaining a portfolio of reasonable size is critical to outperforming other active managers and investable passive alternatives.

Finally, alignment of interests between the manager and client is essential. We recommend investors look at disclosures detailing portfolio manager ownership of the strategy and ask how managers are compensated. While higher ownership levels do not guarantee success or an ethical manager, we believe they improve the client's odds of a positive experience.

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The views expressed are those of Diamond Hill as of September 2018 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.