Investment Perspectives

For high-yield bonds, market volatility can bring new opportunities

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Article Highlights:

- The decline in the high-yield bond market that took place in December— touched off by falling oil prices — proved short-lived.
- While there is likely to be an increase in defaults among energy issuers, the strengthening U.S. economy should keep default rates low in other areas of the economy.
- With interest rates still relatively low, the income available from high-yield bonds is relatively attractive compared to other asset classes.
- There are many different approaches to investing in high-yield bonds. Focusing on higher-quality issues—bonds rated Ba to B—can mitigate some default risk while also offering attractive income opportunities.
- High-yield bonds also have a substantial diversification benefit because of their low correlations with Treasuries and other major asset classes.

High-yield bond prices fell sharply at the end of 2014, as declining oil prices raised concerns of increased defaults by energy companies. But high yield didn't stay out of favor for long.

In the low-interest-rate environment of the last several years, high-yield bonds have emerged as one of the few asset classes that can provide compelling yield and current income. With yields on Treasuries and high-quality corporate bonds not far from their all-time lows, many investors have shifted a portion of their fixed-income portfolios into high yield.

With higher yields, of course, come a higher risk of default and added volatility, though the risk of default can vary significantly for high-yield bonds with different credit ratings. Choosing a strategy that focuses on higher-quality high-yield bonds —those with credit ratings from Ba to B—can help mitigate the risks of default compared with lower-rated bonds while still providing potentially attractive yields and risk-adjusted returns.

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A temporary tumult in the high-yield bond market

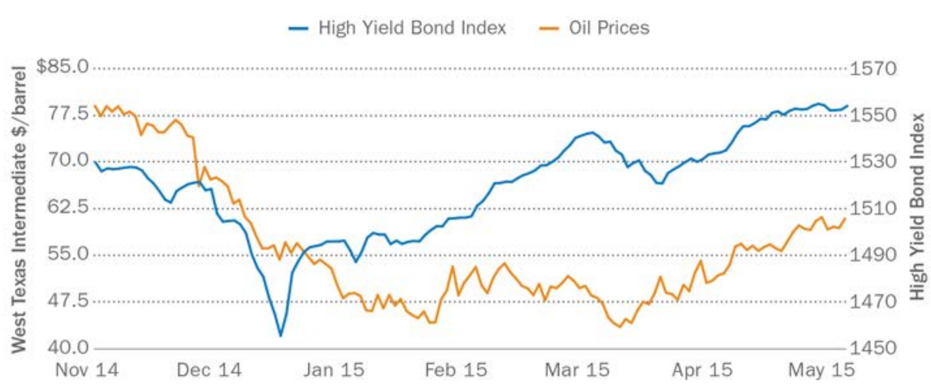
A good example of how volatility can affect high-yield bonds occurred in December 2014. A steady decline in oil prices that had begun months earlier suddenly accelerated, with the price of crude plummeting about $20 during the month of December to a six-year low of about $50 a barrel. That drop raised the possibility that the most highly leveraged oil producers—many of which were small, independent oil producers that borrowed heavily to fund drilling programs in the shale deposits of Texas, Pennsylvania, and North Dakota—might not have the profits and cash flow to meet their interest payments.

Energy companies account for about 18 percent of the benchmark BofA Merrill Lynch US Cash Pay High Yield Index, a market-weighted index that measures the performance of high-yield bonds. This index fell 1.48 percent during December as the drop in oil prices grew steeper.

By March-end, however, the index had regained some of its lost ground, even though oil prices fell further during the period. In December the index's yield spread over Treasuries had widened to 492 basis points (bps) from 460 bps before oil prices began to fall. But by the end of the first quarter the spread narrowed to about 477 bps. Exhibit 1 shows how high-yield bond prices became volatile but then recovered after the initial shock of declining oil prices. Oil prices have also recovered somewhat since then.

Exhibit 1

High yield bonds recovered even as oil prices kept falling



Source: Haver Analytics, Bloomberg

It is not possible to invest in an index. Performance for indices does not reflect investment fees or transaction costs. Past performance is no guarantee of future results.

Short-term volatility, long-term returns

As the events of December show, oil prices and other outside influences can have a significant short-term impact on high-yield bond prices. Over the long-term, however, returns are determined by income and default rates. Investors need to be paid enough in income to offset not only the heightened risk of lending to financially weaker companies, but also the losses experienced as issuers default and repay less than their full obligation. Thus, the yield spread over Treasuries (risk premium) has two components – a premium over the risk-free rate (credit risk premium), as well as a premium to account for the expected losses (loss rate). Subtracting the expected loss rate from the total risk premium reveals the credit risk premium; that is, the additional yield that investors earn for owning high-yield bonds instead of Treasuries, after adjusting for expected losses.

With U.S. economic growth picking up, lower rated bonds – Caa and below – may outperform those with higher ratings because the stronger economy could result in fewer defaults and lower expected losses. That outperformance, however, may prove short-lived. In fact, a TIAA-CREF analysis of long-term credit risk premia for five rating groups shows that lower-rated bonds offered the lowest credit risk premia of the five groups. Case in point: while Caa-C rated bonds carried the highest absolute spread (927 basis points) at the end of December, after accounting for this category's higher historical loss rates, Caa-C rated bonds carried the lowest credit risk premium (194 basis points). Thus they offered the least attractive risk-adjusted return potential.[1]

Exhibit 2

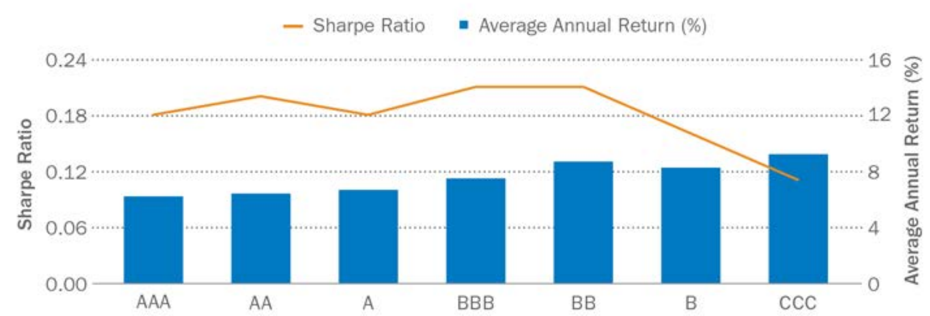
Credit risk premium of US corporate debt by rating

Source: Bank of America Merrill Lynch, Moody's, TIAA-CREF
Results based on 5-yr Average Cumulative Credit Loss Rates from 1982 to 2014
Pricing data as of December 31, 2014

Looking at long-term historical data, such as in Exhibit 3, suggests that lower-rated high-yield bonds may deliver marginally higher absolute total return than bonds with higher ratings, but their risk-adjusted returns—as measured by their Sharpe ratios—were significantly lower.

Exhibit 3

Corporate bonds ratings and returns through 12-31-14



Source: Bank of America Merrill Lynch

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This is the reason that we believe, for investors choosing a high-yield bond strategy, a strategy emphasizing bonds in the mid-to-high-quality segments, such as those rated Ba to B, is a better choice than bonds with lower credit ratings.

Fundamental high-yield bond analysis

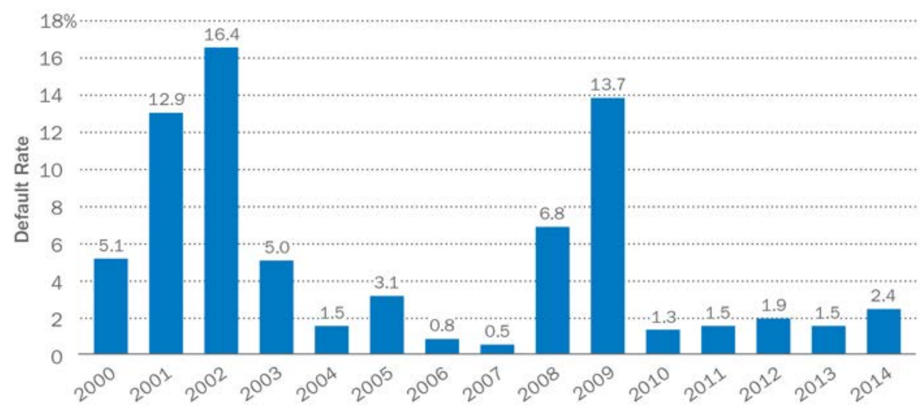
Even within the higher-rated high-yield bond universe, profitability, liquidity, balance sheet strength and debt service capabilities of high-yield bond issuers are what drive default rates. To determine which companies are vulnerable and which are not, it's necessary to look at each company individually. With energy companies, for example, investors need to know how well a company can service its debt in a variety of oil-price environments. Factors to consider include the unique operating risks the different companies face, which geologic formations they are targeting, their product mix (i.e., oil versus natural gas), their cost competitiveness, their hedging programs, their degree of leverage, their capital spending flexibility, and anything else that might influence their future cash flow and profitability relative to debt service.

For high-yield bonds, market volatility can bring new opportunities

Despite the negative impact of falling oil prices, overall high-yield default rates are still historically low. In 2014, high-yield bonds defaulted at a rate of about 2 percent, well below the 4.5 percent long-term average. Although defaults may increase as a result of lower oil prices or other unexpected market events, they are low enough that an upward tick wouldn't diminish the overall attractiveness of high-yield as an asset class. With the U.S. economy on the upswing, there will still be good companies to invest in, even if oil prices stay low or fall further.

Exhibit 4

Fitch U.S. high yield default rate



Source: Strategas

High-yield offers a diversification benefit

Since a stronger economy will likely lead to higher interest rates, it's worth noting that high-yield bonds not only offer higher yield but also the benefits of diversification within a broader portfolio. High-yield returns are more closely correlated with equities than they are with fixed-income sectors that are sensitive to interest rates such as Treasuries and investment-grade corporate bonds. But the asset class is not closely correlated with either equities or high quality bonds, which provides diversification benefits.

Over a 20-year period stretching from January 1993 to the end of February 2013, high-yield bond returns (as measured by the BofA Merrill Lynch U.S. Cash Pay High Yield Index) were negatively correlated with both the 10-year Treasury note and the 3-month Treasury bill. High yield had higher correlations (0.62) with the S&P 500 and Russell 2000 (0.62) over that period than it did with investment-grade corporate bonds (0.56) as measured by the BofA Merrill Lynch US Corporate Index.

For high-yield bonds, market volatility can bring new opportunities

For high-yield investors, volatility is something to be expected. Events like falling energy prices, weak economic data, or even unusual weather patterns can have an impact on high-yield bond prices. Often, issuers will have varying degrees of exposure to the latest developments affecting the market. Some may face severe stress, while others will still have adequate capacity to meet their debt obligations, highlighting the advantages of a selective approach that emphasizes quality. The higher-rated end of the high-yield spectrum may not offer the same yields as lower-rated issues, but the lower risk of default and thus higher risk-adjusted returns over the longer term can offer an especially attractive trade-off when events like a sudden drop in oil prices occur.

For more information on how a higher-quality high-yield approach can offer potentially attractive risk-adjusted returns, contact TIAA-CREF.

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[1] As of April 9, 2015

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