The high-yield bond market has come a long way. Back in the 1980s, these securities were known as “junk” bonds, a new tool that Wall Street and corporate titans used to finance billion-dollar acquisitions. Today, many more companies issue high-yield bonds for a variety of reasons—growth capital, refinancing, acquisitions—and these bonds have become a familiar, important element in a diversified portfolio. For those looking to start investing in high-yield bonds—as well as those looking to increase their allocation—it’s important to be fully educated about the benefits of this asset class and some caveats that apply.

First, what is a high-yield bond? High-yield bonds have a lower credit rating—based on a higher likelihood of default—than investment-grade corporate bonds, Treasury bonds and most municipal bonds. High-yield bonds carry a rating below “BBB” from S&P and below “Baa” from Moody’s, and because of the higher risk of default, these bonds pay a higher yield than investment-grade bonds (thus compensating investors for accepting this added risk). Credit ratings can be as low as “D” (currently in default), and as a rule, the lower the rating, the higher the yield.

When considering investment in the high-yield sector, it’s important not to paint the category with too broad a brush. High yield includes a very diverse group of credits, from those in or near default to those on the verge of being rated as investment grade. This diversity is illustrated by vastly different default rates. Defaults for BB-rated bonds were 8.2% over an average five-year period between 1994 and 2011, while defaults for C-rated bonds were 45.5% for the same time period.

The benefits of high yield

There are several key reasons to include high-yield bonds in a well-diversified investment portfolio. Over the long term, these securities have had strong performance with low volatility relative to equities, as well as low correlation to other types of fixed-income assets.

From 1993 to 2012, high-yield bonds outperformed other fixed-income asset classes with an average annual return of 8.14%, according to the Bank of America Merrill Lynch High Yield Master II Index. During the same time frame, 10-year Treasuries returned 6.77% and mortgage-backed securities returned 6.40%, according to the Mortgage-Backed Master Index. High-yield bonds also outperformed large-cap stocks, which gained 7.41% annually during the period.

Interestingly, the Russell 2000 index of small-cap stocks returned 8.94% from 1993 to 2012, in line with high yield. But investors endured significantly more volatility to generate these equity returns. Volatility, which most investors prefer to avoid or minimize, is typically measured using a common statistical calculation called standard deviation. The higher the standard deviation, the more returns have bounced up and down relative to their average return over a given time period.

By this measure, high yield is much less volatile than equities. During the 1993-2012 period, high-yield’s standard deviation was 8.69, compared to 19.78 for the small-cap group and 15.22 for the large-cap group in the S&P 500. Not surprisingly, high yield was more volatile than 10-year Treasuries (7.44) and mortgage-backed securities (2.85).

Besides attractive return potential and relatively low volatility, another benefit of high-yield bonds is their low correlation with other fixed-income assets. It’s critical to have a portfolio of assets that react differently to economic developments (i.e., that are non-correlated) to build a diversified, resilient portfolio. High correlations might sound appealing when markets are going up, but when markets are choppy or falling, an investor cannot afford to have all investments moving in lockstep.

High-yield bonds, for instance, are less sensitive to interest-rate changes and are more sensitive to economic health (since higher corporate earnings implies issuers can continue to pay their debts). As a result, high-yield bond performance is more closely correlated with returns of large- and small-cap stocks than with other fixed-income securities such as Treasuries, mortgage-backed securities or even investment-grade corporate debt. This low correlation with other fixed-income securities is useful when constructing a portfolio. For example, by adding high-yield bonds to a portfolio of Treasury bonds, an investor may be able to increase annual returns and actually
reduce overall portfolio risk. The reason? Diversification. Because the bond portfolio now holds non-correlated assets, the risk of loss due to a sudden drop in Treasury prices is mitigated.

High-yield bonds essentially act as a middle ground. They are on the riskier end of the fixed-income spectrum, but historically have proven less risky than virtually all equity funds, whether domestic or international, large-cap or small. The net effect is that local and global events—whether the euro crisis, the fiscal cliff, or Federal Reserve policy making—can encourage investors from both ends of the risk-tolerance spectrum to move into high-yield bonds. When conservative investors want to add a little more risk, they often turn to high yield. Likewise, when aggressive investors want to take a little risk off the table, they turn to high yield as well.

The caveats of high yield
The primary risk to high-yield bonds’ long-term performance is default risk. This risk can be significantly ameliorated by holding mostly BB and B credits. Default rates are also held in check by economic growth—even meager growth. Historically, growth over 1% has proven adequate for high-yield issuers to pay their debt service requirements. Recent performance bears this out: Despite an anemic economic recovery from the financial crisis, the default rate for high-yield issuers has been in the 2%–3.5% range, below the long-term average global default rate of 4.8%.

Another caveat for investors is that they should not try to time the market. On a yearly basis, high-yield bond prices can move up and down substantially. As noted earlier, the total annualized high-yield return was 8.14% from 1993 to 2012, but the total annualized price return during that time was negative 1.03%; what’s more, prices dropped by double digits in five of those years, according to the Bank of America Merrill Lynch High Yield Master II Index. But a high-yield bond’s long-term performance is driven not by its price performance but by its coupon—i.e., the interest payment on the bond that the investor receives. No matter how good a portfolio manager is, there will be some price deterioration and losses. Therefore, investors should think of high-yield bonds as a long-term investment.

Finding the right allocation
Despite the high-yield bond market’s many advantages, evaluating and purchasing individual high-yield issues requires deep analysis and substantial expertise. For these reasons, most retail investors choose not to try to pick individual winners on their own. Instead, by buying a high-yield bond fund, a retail investor can enjoy the benefit of professional expertise, institutional pricing power that lowers the cost of buying and selling, and the kind of broad diversification necessary to mitigate default risk and promote long-term returns.

Whether an investor is conservative, moderate or aggressive, an allocation to high-yield may be an appropriate part of a diversified, long-term portfolio. Far from being “junk” bonds, over time these securities have the potential to add significantly to an investor’s treasure chest.

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