The enduring benefits of high-yield bonds

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Article Highlights

• High demand for high-yield bonds has driven up prices and reduced yields to record lows.

• High-yield bonds are an effective portfolio diversifier, helping to reduce volatility and enhance returns.

• High-yield bonds can withstand interest-rate hikes better than other bonds, helping to mitigate interest rate risk.

• There is a wide variation of quality in this asset class, however, which calls for investors to choose a high-yield strategy carefully.

• An actively managed approach backed by strong credit research can help investors manage some of the risk inherent in the asset class.

The benefits of bond diversification

Since the financial crisis, the Federal Reserve has kept the Fed Funds rate at near-zero and implemented a bond-buying program known as "quantitative easing" to maintain a period of ultra-low interest rates. The intent has been to stimulate economic activity by making it very cheap to borrow money. But for bond investors, low interest rates have meant low income.

To compensate, investors have increasingly purchased "high-yield" bonds to earn higher income and returns than are available from safer government and investment-grade corporate bonds. High-yield bonds are rated "non-investment grade" by rating agencies such as S&P and Moody's due to a greater risk of default by the companies that issue them. Despite the higher risk, the intense demand for high-yield bonds has driven up prices and reduced yields to record lows. (A bond’s current yield is calculated by dividing its annual interest payment by its current price; the higher the price, the lower the yield.)
With the Federal Reserve reducing its quantitative easing program and setting the stage for rising interest rates, some investors are rethinking their bond portfolios and wondering whether high-yield bonds adequately compensate for the higher default risk compared to investment-grade corporate bonds and Treasuries.

But our research shows that despite the shifting interest rate environment, there are several attractive benefits to continued investment in high-yield bonds. For starters, high-yield bonds add important diversification to a portfolio because they react differently to market events than other bonds, holding value or rising when other bonds fall. Thus, somewhat counterintuitively, adding riskier high-yield bonds can reduce overall portfolio risk and boost returns over time.

For example, over the past two decades, high-yield bonds have reacted differently to market events than Treasuries. Because of this characteristic, adding high-yield bonds to a portfolio of Treasuries can reduce volatility and risk. What’s more, adding high-yield bonds can actually improve returns. According to our research, if an investor with a bond portfolio made up of only Treasury bonds shifted 30% to high-yield bonds, the annual return would improve by almost one full percent while reducing volatility by 1.2%.

Besides behaving differently than investment-grade bonds, high-yield bonds have also historically outperformed them. Between 1993 and 2013, high-yield bonds (represented in the BofA Merrill Lynch US Cash Pay High Yield Index) earned an average annual return of 8.63% versus 5.95% for investment-grade bonds. In fact, in terms of returns and volatility (volatility measures how much a bond’s price moves up and down), high-yield bonds occupy a middle ground between investment grade bonds and stocks, which make them a great addition to a portfolio.

**Mitigating interest-rate risk**

Besides these diversification benefits, high-yield bonds have another important advantage: they are less sensitive to interest-rate fluctuations than other types of bonds in a portfolio, which is a very valuable characteristic considering that we expect interest rates to generally rise over the next few years.

In fact, in prior periods of relatively moderate and steady interest rate increases such as we may now be facing, high-yield bonds actually outperformed. Between 1998 and 2013, there were 14 different periods when the 10-year Treasury rate jumped by half a percentage point or more (which is a lot in the world of bonds). During these periods, returns for investment-grade corporate bonds returned a negative 0.48% and 10-year Treasuries returned a negative 5.53%, while high-yield bonds posted a positive return of 4.99% (see Exhibit 1).
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There are two reasons that high-yield bonds are less sensitive to interest-rate increases. First, their higher yield compared to other bonds gives them a natural cushion against rising rates. Second, rising rates often signal an improving economic environment, rising corporate profits and stronger balance sheets—all of which tend to reduce default rates among high-yield bond issuers and raise the value of outstanding high-yield bonds. For high-yield bonds, the benefits of an improving economy often outweigh the negative impact from rising interest rates.

High Yield vs. Really High Yield

Even with their lower interest-rate sensitivity and diversification effectiveness, are high-yield bonds still attractive, given yields are at record lows and apt to rise? Compared to higher-grade alternatives, the answer is yes. In April, the yield of high-yield bonds stood at 5.22%, which was still about two times the 10-year U.S. Treasury yield of 2.65%—a considerable spread in today’s low-rate environment.

The question then becomes: Do the rewards offset the current risks? The primary risk with high-yield bonds is default risk, and in an improving economy this threat lessens. However, default rates aren’t evenly distributed across the high-yield market. The lowest-rated bonds have a much higher chance of default.

Bond ratings from the rating agencies are expressed as letters ranging from 'Aaa', which is the highest grade, to 'C', which is the lowest grade. Thus a grade given to a bond indicates its issuer’s financial health and ability to repay its debt. (Different rating services use the same letter grades, but use various combinations of upper- and lower-case letters to differentiate themselves.)
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According to Moody’s, over a series of rolling five-year periods between 1994 and 2013, 6.5% of Ba-rated bonds and 17.7% of B-rated bonds defaulted, versus 38.0% of bonds rated Caa to C. After adjusting for losses using historic average cumulative credit loss rates published by Moody’s, our analysis shows that Caa-C rated bonds at current yield levels compared to Treasuries are not cheap enough to properly compensate investors for the historic loss. Thus, choosing a fund that invests heavily in Caa-C bonds might not be the best strategy. It is better to select a fund or strategy that actively manages a portfolio of predominately mid- to high-quality high-yield bonds, such as those rated B and Ba, rather than bonds with the lowest credit ratings.

Managing default risk

Despite the many compelling reasons to invest in high-yield bonds, the loss of principal remains a risk given their higher default rates. For this reason, investors benefit from active management of high-yield bonds that’s backed up by proprietary research. Additionally, our advice models recommend limiting high-yield exposure between 3% and 8% of your overall portfolio, depending on your risk tolerance. We suggest working with a TIAA-CREF financial advisor who can provide insight on various high-yield strategies and funds.

1 The calculation is based solely on historical returns and standard deviations for the period 1/1/1993 through 2/28/2014.

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