

# GLOBAL HIGH-YIELD BONDS AN UPDATE

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## INTRODUCTION

In January 2012, Mercer released a paper outlining our views on high-yield bonds. In that paper, we suggested that it was an opportune time for investors to make a strategic allocation to high-yield bonds.<sup>1</sup> At the time, we believed that with wide spread levels, it was also an attractive point for a tactical allocation. High-yield bonds offer attractive returns over time with less volatility than equities and it should offer more downside protection than the equity market typically provides. However, over longer periods we would expect equities to exhibit higher returns, as they are the riskier asset class, being lower in a company's capital structure; theoretically, this should mean that investors receive a higher reward for the extra risk they are taking.

In this paper, we look at a number of issues:

- The strategic case for high-yield bonds.
- Recent performance of the asset class since 2012.
- The cyclical nature of the asset class and where we think we might be in the current cycle.
- How the timing of investments affects future returns and how spreads and default rates drive returns.
- How high-yield bonds might perform in a rising rates environment.
- How high-yield bonds fit into growth-oriented fixed-income portfolios or into a multi-asset credit fund.

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<sup>1</sup> By "high yield," we mean an allocation to noninvestment-grade fixed income, with a typical benchmark being the Merrill Lynch Global High Yield Index.

## STRATEGIC CASE FOR HIGH-YIELD BONDS

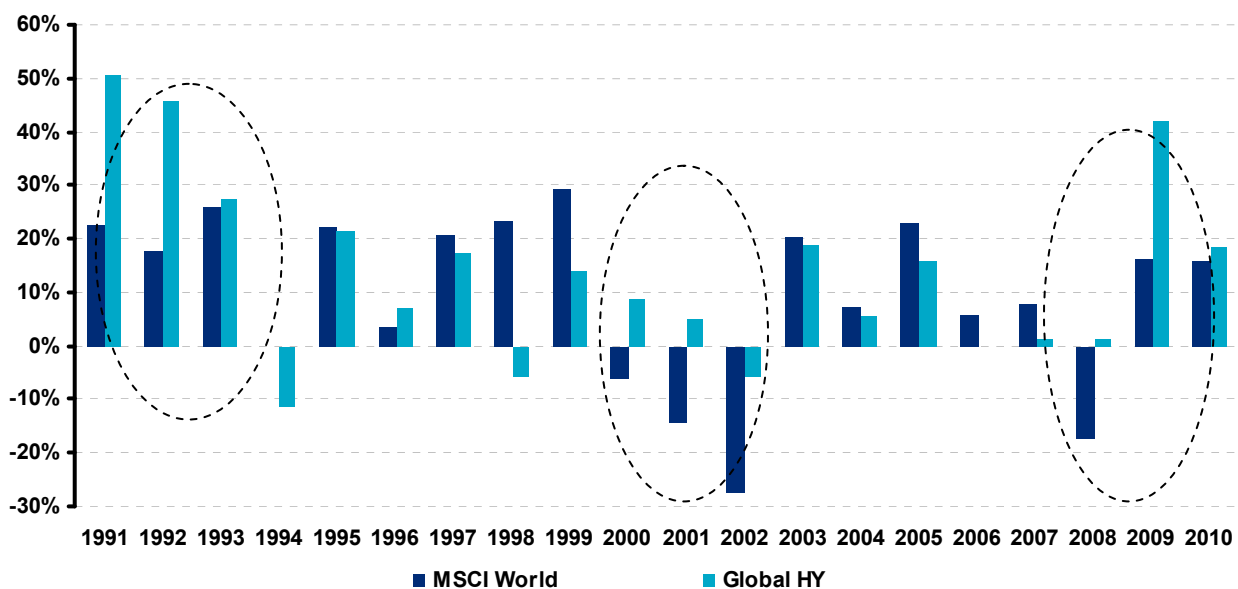
To reiterate what we discussed in our January 2012 paper introducing this asset class, high-yield bonds:

- Have historically provided excellent risk/return characteristics.
- Help diversify the source of returns in the growth portfolio away from traditional equities.
  - There are different companies in the High Yield universe compared with the predominantly large cap companies in equity and investment grade credit indices
  - Bonds are higher up the capital structure than equities and the return profile is different, reflecting returns to credit as well as general corporate health.
- Have a defensive but cyclical nature.

## DEFENSIVE NATURE OF HIGH-YIELD BONDS

The January 2012 paper showed that, over the past 20 years, high-yield bonds have provided better returns than public equities with lower volatility. Indeed, when considering how risk impacts the frequency of and extent of negative returns, high-yield bonds have compared very favorably with equities over this period, avoiding large losses during the bursting of the tech bubble in 2000 and during the global financial crisis in 2007–2008. This is shown in the chart below.

**Global High-Yield Bond and Global Equity Returns**



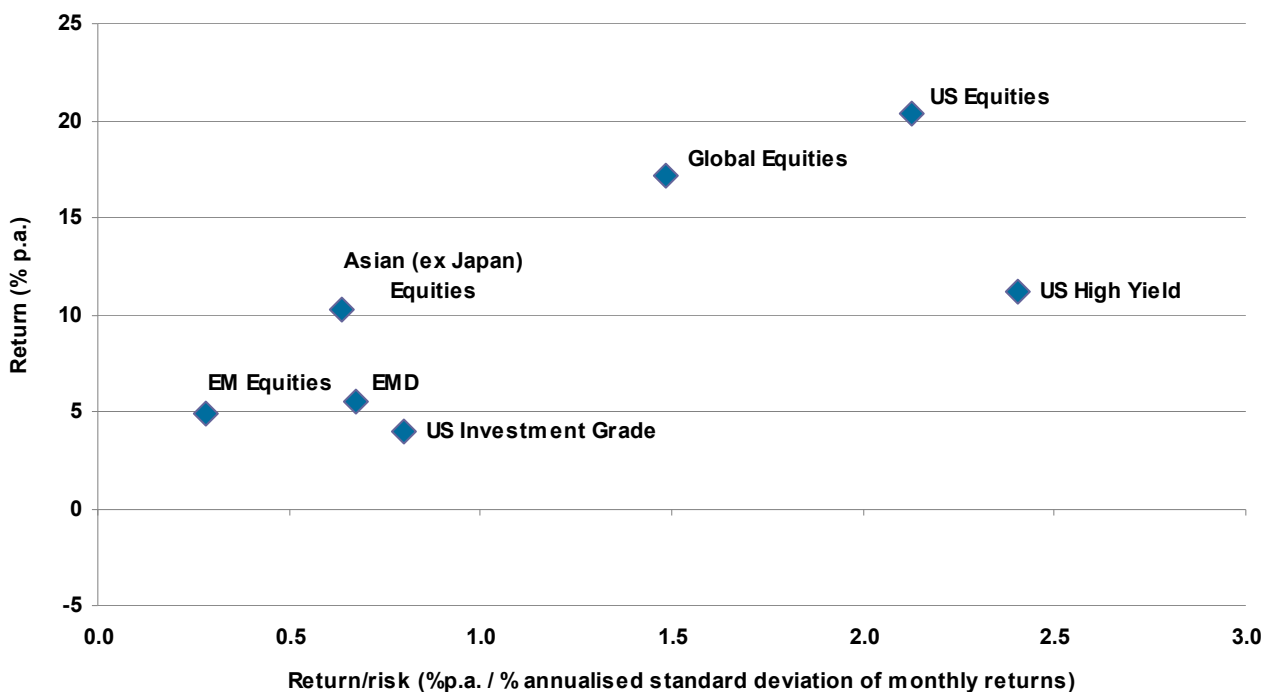
Source: Thomson Reuters Datastream

The equity market has more potential upside than high-yield bonds, but it also exhibits times of severe downside that high-yield bonds tend to avoid. By avoiding large losses, the cumulative performance of high-yield bonds has been better over this period.

## RECENT PERFORMANCE OF HIGH-YIELD BONDS

High-yield bonds have had robust performance since the start of 2012 until the end of June 2013, although there has been a small sell off recently. Below we have charted the performance of a number of major asset classes over this time period showing the return they produced plotted against the return for every unit of risk taken. In this case it shows return per unit of risk as measured by standard deviation.

**Return vs Return/Risk (Dec 31, 2011 to June 30, 2013)**



Source: Thomson Reuters Datastream (Indices used: MSCI EM, MSCI World, MSCI AC Asia ex Japan, S&P 500, Barclays Capital US Aggregate Government, Barclays Capital US Corporate Investment Grade, Bank of America ML US High Yield Master II, JPM EMBI Global Diversified)

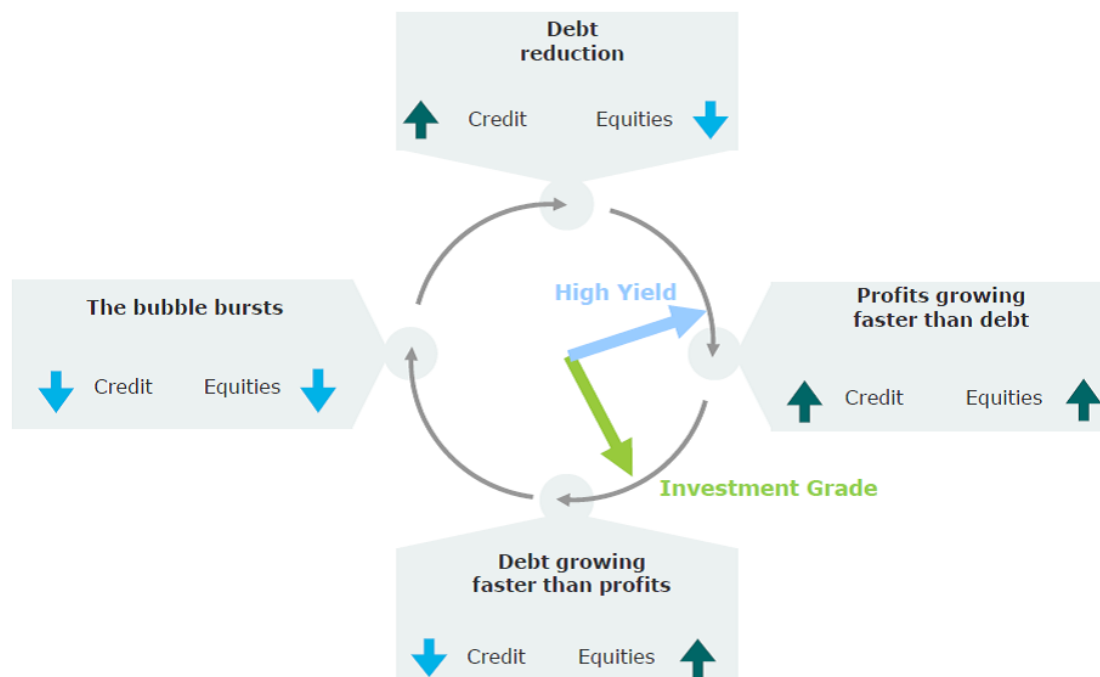
Although high-yield bonds were only the third-best performers on this chart behind US equities (S&P 500) and global equities, it still returned an annualized 11.2%. More impressively, it was the best performer in terms of return for risk taken. This was largely due to the lower volatility of the asset class over this period; this lower absolute level of volatility is something we would expect to see over the longer term.

## CURRENT ECONOMIC CYCLE

Of course the recent impressive performance of the asset class does not mean that the future performance will be equally impressive. In fact we now believe that returns from the asset class over the next couple of years could be muted and we would be very surprised to see the performance of the 18 months up till the end of June 2013 repeated in the near future. The main reason for this is that spreads have tightened dramatically over the period of observation. In January 2012 the Merrill Lynch Global High Yield index started the year with a spread of 807bps, by the end of June 2013 this had fallen to 554bps. This spread tightening has driven the performance of the asset class.

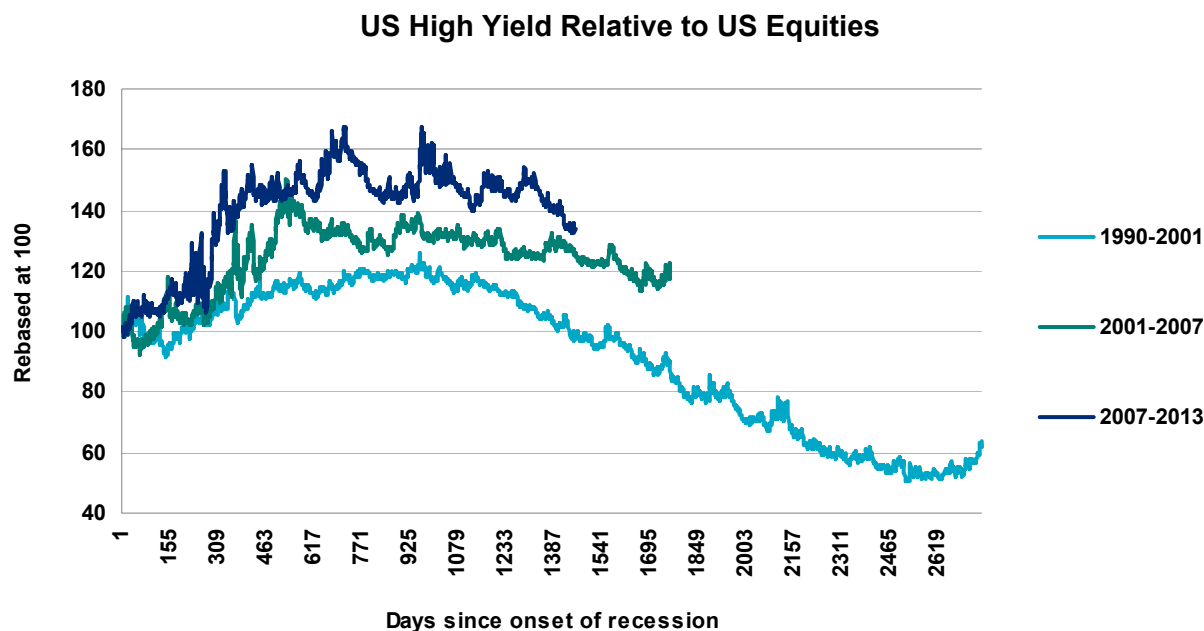
In our previous paper, we pointed out how high-yield bonds are a cyclical asset class that tends to perform better than equities in the early stages of the business cycle. This is shown on the following diagram. As companies enter and go through a recession, they tend to focus on reducing their debts (also commonly referred to as deleveraging) to help ensure survival during the hard times. During this debt-reduction phase, credit will outperform equities. Once companies come through this debt-reduction phase and the economy recovers, profits start to grow faster than debt. While this period is good for credit, it is also good for equities as profits are rising. We suspect that we are somewhere near the end of this period in the business cycle. After that, debt starts to grow faster as companies look to improve equity holder returns and add leverage to help make this happen. This causes credit to underperform as equity holders see enhanced returns, while the risk to debt holders increases. Finally, this increased leverage could lead to the next recession — but we think we are long way from that at the moment.

### High-Yield Bonds Performance and the Business Cycle



Source: BlueBay

Another way of examining this cycle is to see how high-yield bonds perform in relation to equities through the cycle. We have done this for the past two business cycles, using US high-yield bonds and US equities, and also show the relative performance of the asset classes through the current cycle. We took the data from the start of a recession and tracked the numbers to the start of the next recession. This is shown in the following chart.



Source: Thomson Reuters Datastream

This chart, in some ways, shows how hard it is to talk about the “average cycle,” as every cycle is different. The period 1990–2001 showed high-yield bonds initially outperforming equities, as we would expect however equities then go on a long extended period of outperformance, outperforming high-yield bonds considerably over the full cycle. This cycle was the longest period of uninterrupted growth in US history; it also combined with the “tech bubble” of the late 1990s that drove equities to extremely high levels. We would not normally expect to see equities outperform by quite so much.

In the period 2001–2007, high-yield bonds once again outperformed through the recession and slowly gave some ground back toward the end of the cycle. Over the full cycle, this time high-yield bonds posted the best performance. As we noted earlier, we would not have expected this, as equities — being the higher risk asset — should, in theory, outperform over the full cycle. Finally, the line that charts the latest cycle shows high-yield bonds having an extremely large outperformance of the equity market; however, this outperformance has slowly scaled back in recent months.

So how confident can we be that investors will not experience negative returns if investing in high-yield bonds today?

## INVESTMENT TIMING

One way is to look at the level of portfolio defaults required to leave an investor with only a return of initial capital after a certain period. This way, once we have estimated the level, it is possible to judge whether the economic outlook is better or worse than this number of defaults suggests. The default rate required to bring about a breakeven investment could be considered the “margin of safety” that an investor has.

To do this, we took a five-year period, which tends to be around the timeframe of a normal business cycle. We then had to make some assumptions to simplify the model. We assumed that recovery rates remain stable at 30%. Normally, when a bond defaults there is some form of recovery value that the bond investors receive after other creditors have been paid. The average recovery rate for high-yield bonds tends to be higher than this. However, actual recovery rates will ultimately depend on the prevailing economic conditions. Since 2000, the best year for recovery rates was 2007 with a rate of 66.4%, and the worst was 2000 with 24.9%.

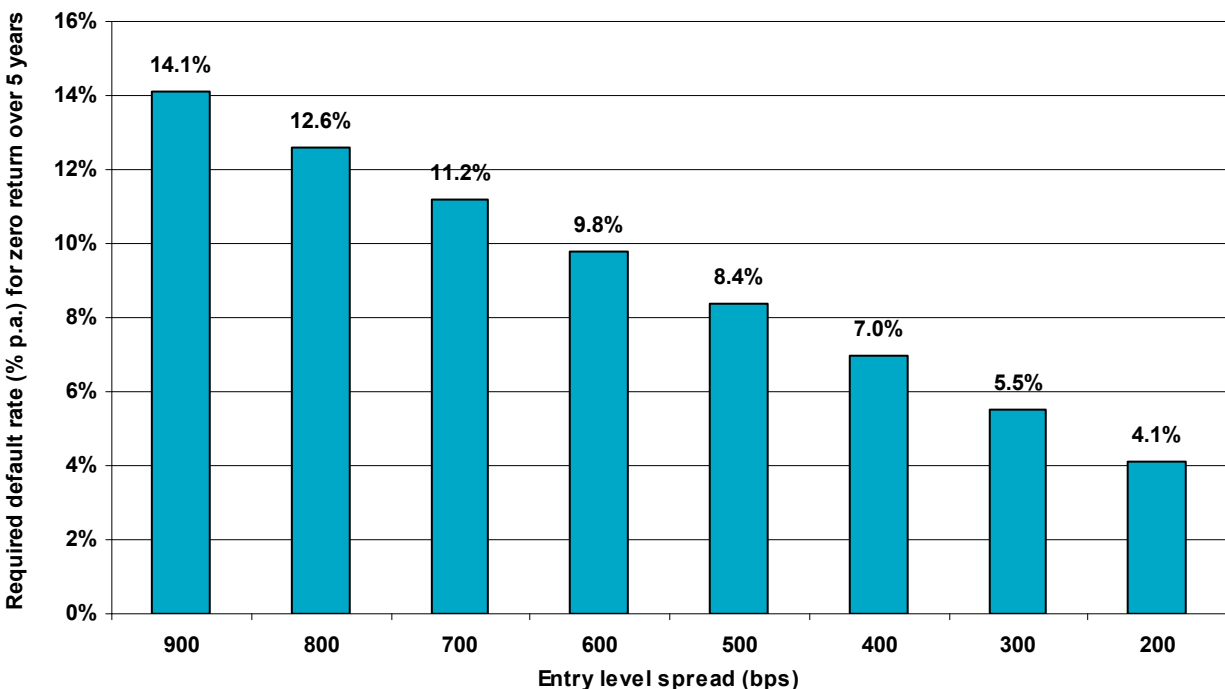
Another assumption that we made was that base interest rates remain constant. In this case, we kept rates at 0.9%. If this rate was higher initially, then it would improve returns over time and mean that default rates would have to be higher to reach a breakeven point. We also kept spreads constant over the whole period, something that would obviously not happen in the real marketplace, as they move on a daily basis.

Finally, we assumed that all the companies that were there at the start of the five-year period were the same ones at the end, unless they defaulted. Once again, this was a big assumption to make, as the high-yield market tends to be quite dynamic with new companies coming to market; some companies leaving the market as debt is repaid; some defaulting; and some being acquired.

Despite these limitations to the model, we believe that our results are still a good indication of possible value in the market. The results of our work are shown in the chart on the next page.



## Annual Default Rates Required for a 0% Return Over Five Years



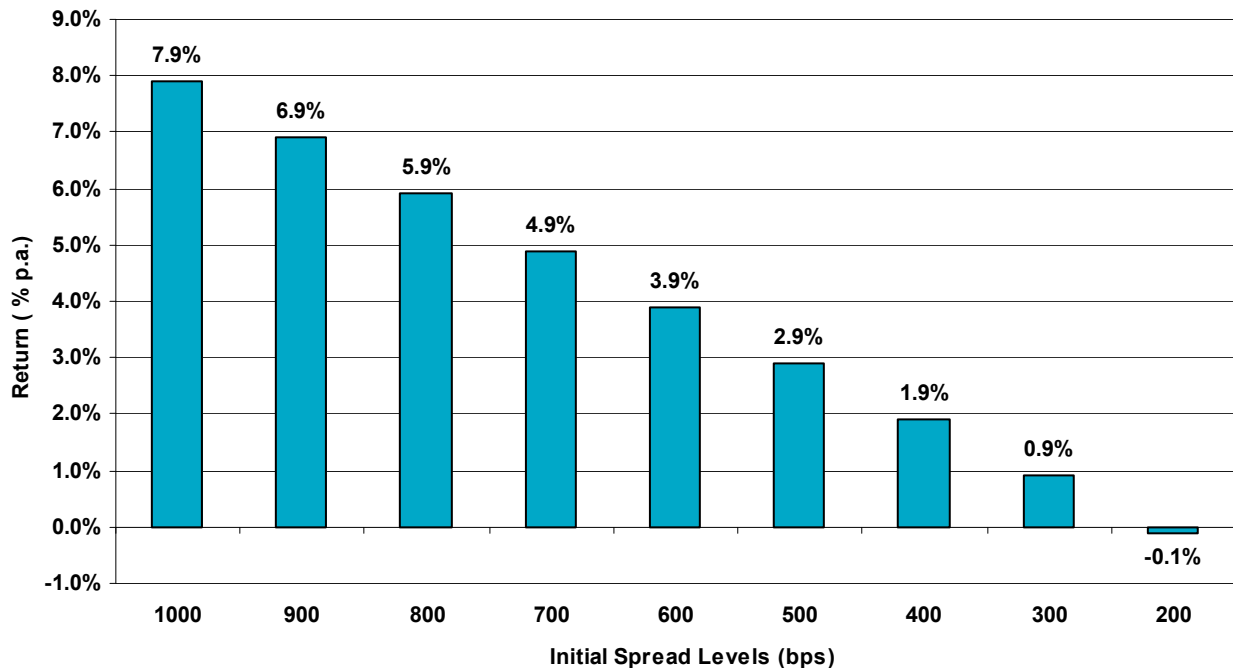
The chart shows the annual default rate required for an investor to have a zero return over five years if an allocation was made at a given spread level. For example, if the investor entered the market at a spread level of 700 bps, then the investment would have to experience a default rate of 11.2% per annum (with a recovery rate of 30%) to experience a 0% return over the five-year period. This is a cumulative default rate of 48%, meaning that of the initial companies invested in, nearly half of them would default over the time period. To put this into historical perspective, we have data going back to 1920 and the worst-ever five-year period experienced an annualized default rate of 9.2% per annum in the 1930s during the Great Depression. In contrast, the best-ever five-year period in the history of high-yield bonds was in the 1950s, when the annual default rate was 0.2%.

To represent this in terms of valuation, we believe that spreads of 600 bps and higher would represent a decent entry point to the market. In theory, at that level, it would require a default record over the next five years worse than at any period in history to lose money. We consider this a large margin of safety for investors. If markets turned out more benign, then an investor could reasonably be expected to profit in this period.

## PROSPECTIVE FUTURE RETURNS

To build on this, we also evaluated what kind of return an investor might expect given a certain default rate. The following chart shows expected returns with an average default rate of 4.2% per annum. This was the average default rate over the period 1980–2010. We kept all the other variables the same as in the first chart. The average default rate over the period 1920–2010 is significantly lower at 2.7%.

**Five-Year Annualized Returns Assuming Average Default Rates**



As would be expected, the higher the spread when entering the market, the better the long-term returns. However, it must be noted that when spreads are at their widest, this is always accompanied by stress in the market. Investors tend to be looking for safe investments at these times, so making an allocation at these levels is not an easy decision to make.

Taking this back to valuation, we would once again look to invest if spreads were higher than 600 bps. This could result in an annualized return of 3.9% or better if spreads were higher at the entry point. Although 3.9% a year does not sound like a particularly high return, when we consider that 10-year government bond yields in the UK, Germany, and the US are all below 3.0%, we believe that this is an acceptable return in the current market. When we combine this with the exceptionally high default rates required to lose money over this period, we are comfortable with the entry point.

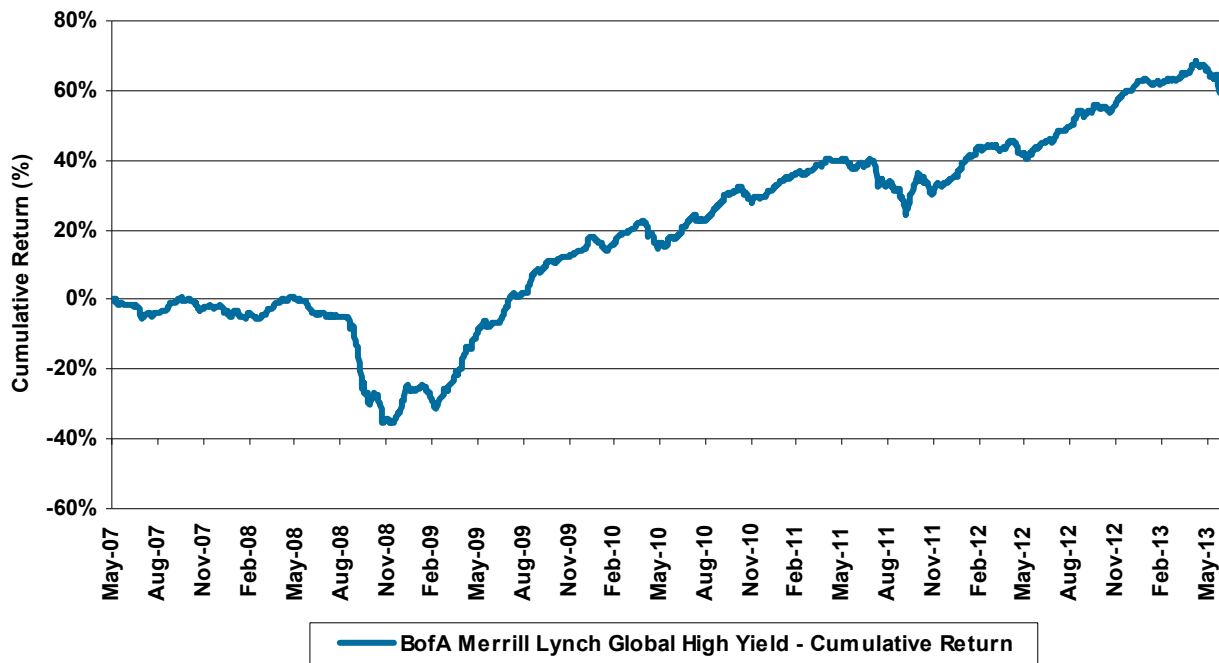
## DOWNSIDE RISK TO OUR ASSUMPTIONS

It is interesting that all our valuation metrics come up with similar outcomes. What we must stress, however, is that these are looking at the asset class over a five-year period, not as a short-term tactical investment. Probably the biggest risk to our assumptions would be a major dislocation in the market; the most obvious current contender for this would be a breakup of the eurozone.

If such an event were to occur, then spreads would almost definitely rise dramatically, resulting in substantial mark-to-market losses. However, over a five-year holding period, the probability of a significant loss would seem small.

We have looked back over the past 20 years to find the worst-possible entry point to invest in the high-yield market. This would have been on May 28, 2007, when the high-yield index had a record-low spread of 233 bps points. It was also just before the credit crunch started to impact markets. Over the next five years, an investor entering the market at that point would have made a return of 7.1% per annum. However, if the same investor had sold out at the worst possible point, in November 2008, the loss would have been 35.5% of their investment. This is demonstrated in the chart below, which shows the cumulative returns over the five-year period. It must be noted that the index return includes new issues added over time that had much higher yield levels than the initial level.

**Cumulative Returns over the Five-Year Period**



Source: Thomson Reuters Datastream

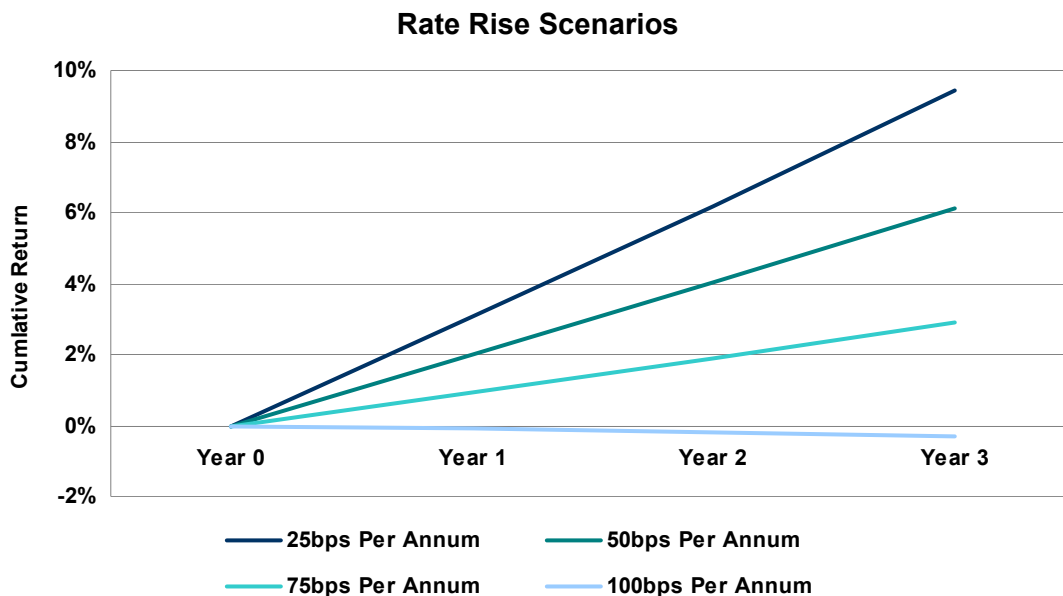
We believe that high spread levels can offer investors a good margin of safety over the mid to longer term. When markets are experiencing high levels of stress, they can easily overwhelm solid fundamentals. It is probably fair to add that, during such periods of market stress, all risk assets would suffer and historically high yield has held up much better than equities at such times.

## EFFECT OF RISING GOVERNMENT BOND YIELDS

So far, our analysis has largely concentrated on spreads in the high-yield market. However, the total yield on a high-yield bond is made up of a component that represents the current government bond yield and the spread that is then added on top of this. It is widely believed that government bond yields are going to rise over the next few years and may do so considerably from the current low levels.

At the end of June, the total yield to maturity on the Merrill Lynch Global High Yield Index was 7%. This is made up of a spread of 554 bps and a government bond yield equivalent of 146 bps. In the past, a rising government bond yield had little effect on the high-yield market, as the increase in the government bond yield would have been small in comparison to the total yield in the market. On top of this, the duration of the high-yield market tends to be short, so the rise in yields had a smaller effect than in markets with longer duration. In the current market, a 1% increase in government bond yields will have a significant impact on the market because of lower overall yields, although duration is still small in comparison to other markets. How much of an impact rising yields will have is governed by the speed of the rise. A dramatic rise in yields over a short period would result in a large loss for bond holders. A slow rise over time would result in muted returns for bond holders but no overall losses.

Of course, trying to predict the speed of bond yield rises and where they will eventually rise to is difficult. Instead, in the chart below we have shown a range of scenarios in which government bond yields rise by a fixed amount per annum over the next three years, ranging from 25 bps a year to 100 bps a year. The lines show the total return in the high-yield market, assuming an average default rate of 4.2%. In reality, we would probably expect higher returns, as the rise in government bond yields would result in new issues having higher starting yields. Also, rising yields are normally associated with a strong economy, which would suggest lower default rates. However, for consistency with our other calculations, we kept yields static over the period.



It can clearly be seen that the faster bond yields rise, the lower the return over the period. Under our worst-case scenario, the government bond yield would have increased 3% over the period, and this would result in a total return of -0.3%. It must be noted that the market is currently pricing in interest-rate rises significantly lower than this.

## GAINING ACCESS TO THE MARKET

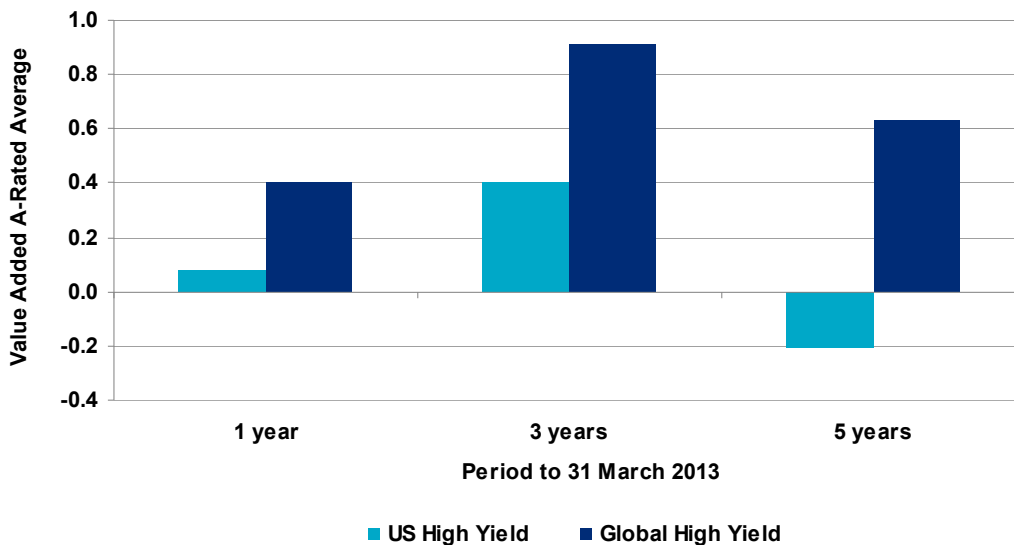
### **Active vs. Passive**

Index-tracking exposure in the high-yield market is problematic. Replicating the index is difficult and expensive. High-yield bonds go in and out of high-yield benchmarks far more often than stocks go into or out of equity-related indices. This creates high turnover and transaction costs for index-tracking funds. Many high-yield bonds are illiquid, with many transactions taking place in a relatively opaque market that trades off-exchange, infrequently, and with high associated trading costs.

Data from Bloomberg show that over the five-year period ending May 2012, the only US high-yield ETF available underperformed its benchmark index by 4.1% per year. Not only do high-trading costs hit ETF performance, but they will include all the companies that fail and have to absorb losses from these defaults.

For these reasons, we believe that active managers have a good chance of outperforming in the high-yield market. In the chart on the next page, we show the Mercer A-rated universe outperformance for both the US and the global high-yield markets. The outperformance shown in the chart is fairly modest over all periods, but this is largely a function of manager style. The Merrill Lynch Global High Yield Index returned more than 70% in the five-year period. Normally, in periods when the index is performing so well, managers struggle to keep up, remaining cautious of investing in the lowest-rated or weakest companies. These are normally the companies that perform the best in rapidly rising markets, as they have the highest yields, and when prices are depressed they rally the most. However, the more cautious approach of our A-rated managers means that they normally have much lower default rates than the index, and this leads to outperformance over time. This is especially the case when the market sells off.

## Mercer A-Rated Universe Outperformance (US and Global High Yield Markets)



## HIGH YIELD AS PART OF A BROADER FIXED-INCOME MANDATE

We recently published a paper titled “[Constructing a Growth Fixed Income Portfolio](#),” which examines a number of ways of combining different fixed-income assets to create a growth portfolio. In all of these portfolios, high-yield bonds play a part to a greater or lesser extent. The allocation to high-yield bonds can be achieved either by a direct allocation or through access to a multi-asset credit fund. This gives clients two ways of entering the market.

If clients choose to invest directly, as this paper has pointed out, they may wish to wait for a more opportune moment to invest, when spreads are higher or when government bond yields have risen further. This would mean that they could delay implementing a full fixed-income growth portfolio or allocate to other asset classes temporarily and increase the high-yield allocation over time as markets present better opportunities.

Of course, decisions like this one normally require a high level of governance. For those clients who may be uncomfortable with making such a decision independently, a multi-asset credit fund may be a good option. In this approach, a manager will invest across a number of credit asset classes and will be tasked with making the asset-allocation call between them. In this way, the manager will be responsible for identifying appropriate entry and exit levels for high yield while using other credits to achieve returns and to try to reduce volatility.

## SUMMARY

Despite the rally in the high-yield markets over the past 18 months and the risk of a rising-interest-rate environment, we still believe in the asset class as a strategic allocation. This would be added to a growth portfolio as a diversifier to other risk assets, such as equities. The asset class continues to offer downside protection in relation to equities. In fact, one of the main concerns around the asset class at the moment is that government bond yields might increase. This would suggest that the economy is performing well and that other risk assets would be performing well. Even from these relatively low spread levels, an unexpected economic slowdown would almost certainly result in much larger losses from holding equities than from high-yield bonds.

Although we are still confident in the long-term attributes of the asset class, we do believe that, in the current cycle, the best returns from high-yield bonds could be behind us. While we do not see a large sell-off in the asset class, unless economic fundamentals deteriorate dramatically, we would probably expect low-to-mid-single-digit returns over the next few years. For investors who want returns higher than this, we recommend waiting for a more opportune entry point. This would be when spreads are higher, government bond yields have risen, or a combination of both has pushed up the total yield in the high-yield market. Of course, for investors who are content with returns like we have outlined and the lower volatility that the high-yield market displays (relative to equities), they may be happy to invest at current levels.

## IMPORTANT NOTICES

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