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AEGON Asset Management

The evergreen appeal of high yield bonds

August 2022

Executive summary

High yield bonds have unique characteristics compared to conventional fixed income securities. With attractive risk-adjusted returns, strong diversification benefits and low interest-rate sensitivity, we believe they can play a key role within client portfolios.

High yield bonds are frequently misunderstood, with an undeserved reputation for being high risk. We view them as a hybrid asset class, sitting between equity and traditional debt markets. In our view, high yield bonds exhibit compelling characteristics compared to many other parts of the fixed income market.

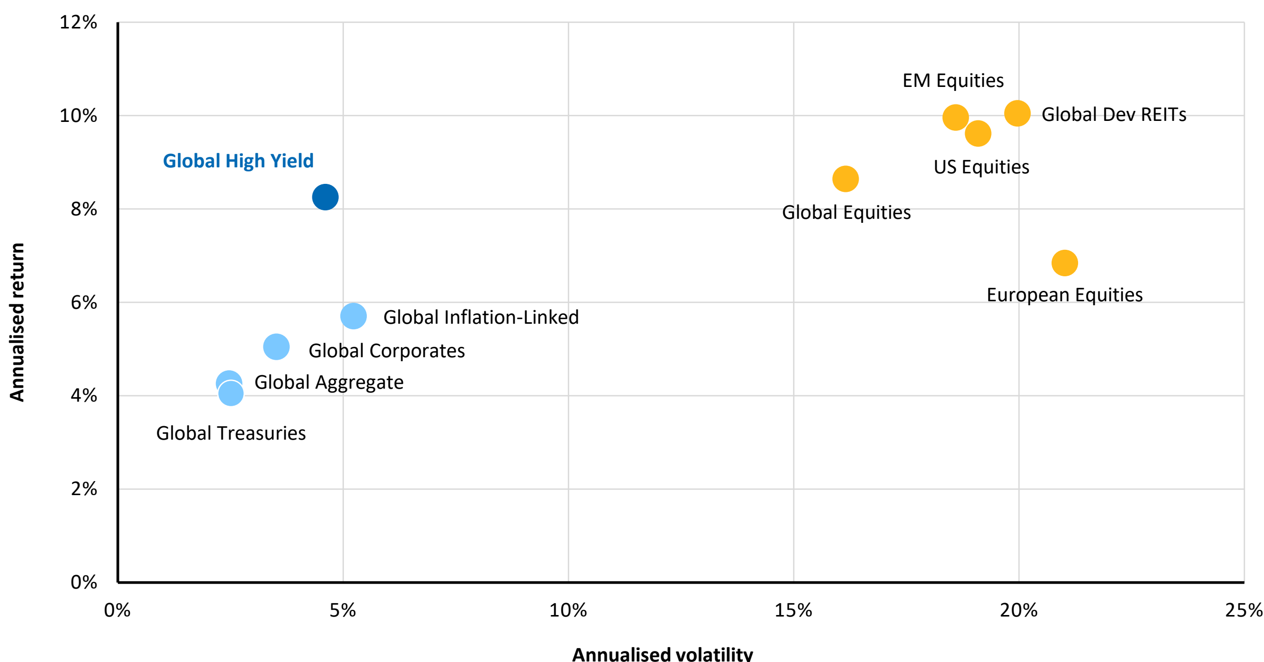
Key factors supporting the evergreen appeal of high yield bonds include:

Enhanced risk-adjusted returns	Attractive income	Lower interest-rate risk	Diversification benefits
High yield bonds have historically generated equity-like returns, but with significantly lower volatility, so offer compelling risk-adjusted return potential relative to other fixed income assets.	High yield bonds offer enhanced income potential due to their healthy spreads over government bonds.	High yield bonds tend to have a shorter duration profile than many other fixed income assets. This can help investors to reduce interest-rate sensitivity and dampen the effects of rising rates.	High yield bonds have historically had low or negative correlations to other fixed income assets and equities, helping investors to diversify their portfolios.

Enhanced risk-adjusted returns

For a given level of risk, high yield bonds offer attractive returns. Exhibit 1 highlights the strong risk-adjusted returns of global high yield bonds over a 20-year period compared to a selection of other asset classes.

Exhibit 1: Annualised risk and returns of the global high yield index vs other asset classes



Annualised Source: Bloomberg, Lipper, MSCI, FTSE over a 20-year period to 31 December 2021. Total-Return, Local-Currency annual standard deviation based on daily returns. Indices used to represent asset classes are as follows: Bloomberg Global High Yield TR for 'Global High Yield', Bloomberg Global Aggregate Corporate TR for 'Global Corporates, Bloomberg Global Treasury TR for 'Global Treasury', MSCI AC World TR LC for 'Global Equities', MSCI USA TR USD for 'US Equities', FTSE EPRA Nareit Developed TR USD for 'Global Dev. REITS', MSCI EM (Emerging Markets) TR LC for 'EM Equities'.

Income rather than price drives total returns in high yield

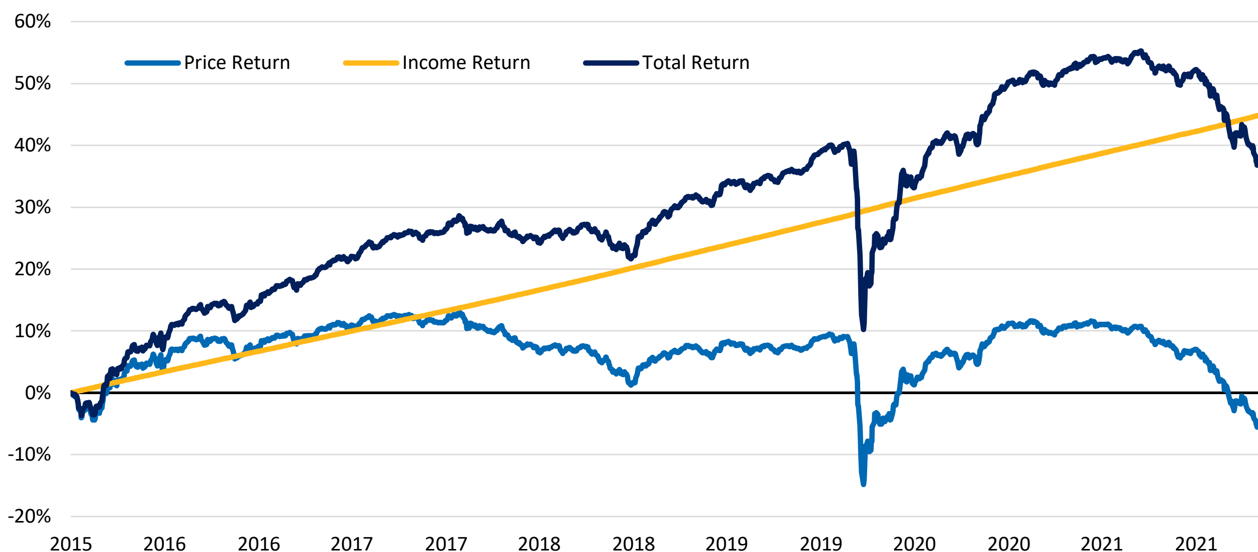
For most risk assets, total return is achieved predominantly via capital price return, but this is not the case for high yield. Over long-term periods, income tends to drive the bulk of the total return for high yield bonds.

The return that investors earn from holding high yield bonds can be broken down into two components: income return and capital return. The income return derives from the interest you earn by holding the bond, while the capital return derives from any change in the bond's price.

As Exhibit 2 shows, over 100% of the cumulative total return in global high yield since January 2015 has come via income. The example shows that income accrues over time and, while the price/capital return moves around, it is a much smaller part of the overall total return. Looking at monthly data from 2015-2022 income has comprised around 85% of the total return, as most bonds are taken out above par. We believe this highlights a critical point - it is not timing the market that is important in high yield, but rather, it is the time *in the market* that drives long-term returns.

For asset allocators interested in timing their entry to the asset class, it is important to remember the value of income over time. For this reason, we believe a strategic allocation to high yield offers compelling opportunities to generate high income and competitive long-term returns.

Exhibit 2: Capital and income return decomposition of the global high yield index



*Source: Bloomberg and ICE BofA as at 30 April 2022. Based on the ICE BofA Global High Yield Constrained Index. Past performance does not predict future returns.

A strategic allocation to high yield bonds can be supplemented by tactical increases or decreases, depending on current valuations. This dynamic approach can help investors to capitalize on income and capital appreciation opportunities. For example, when valuations are relatively cheap and the potential for capital appreciation looks compelling (as we are seeing in the current environment) an increased allocation to high yield may help to enhance long-term total returns. While price movements are a component of total returns, the ability to 'harvest income' typically drives long-term returns in this asset class.

Why is it that income dominates high yield total returns? The asset class effectively has a capped capital upside, due to the mathematics that underlies bonds. Bonds generally price and mature at par. As such, as a bond approaches maturity there is a powerful 'pull-to-par' effect that draws the bond price back towards par before it matures. Since high yield bonds are relatively short-dated, with an average maturity of around 5.5 years, this pull-to-par begins sooner relative to longer-dated bonds. Furthermore, most high yield bonds are callable at a certain price (usually a percentage of the coupon) from a certain date. The call option effectively creates a price ceiling whereby the issuer can call the bond at that price. This means that bonds usually do not trade far above the call price because of the capital loss should the issuer call the bond.

The appeal of this primarily income-driven return profile is that your income return is independent of the capital price, which we have shown can be negligible over the long term. The consistent accrual of income can smoothen volatility, especially when compared to more price-return focused asset classes, such as equities.

Despite some investor misconceptions that high yield bonds are riskier and lower-returning than equities, the data shows that high yield delivers similar returns, but with much lower volatility (Exhibit 3). This is why we refer to high yield as an 'evergreen' asset class and one that can play a key role in investors' long-term asset allocations. Furthermore, high yield bonds can be used as a risk management tool. For example, if an investor's portfolio needs more risk, then the fixed income portion of their portfolio can be 'risked-up' into high yield; if an investor wants to de-risk, then the equity portion can be 'de-risked' into high yield.

Exhibit 3: 20-year annualised total return and volatility

	US High Yield	S&P 500
Total return	7.8%	9.5%
Volatility	5.0%	19.1%

Source: Bloomberg, BofA, as at 31 December 2021. Indices are ICE BofA US High Yield TR index and S&P 500 index.

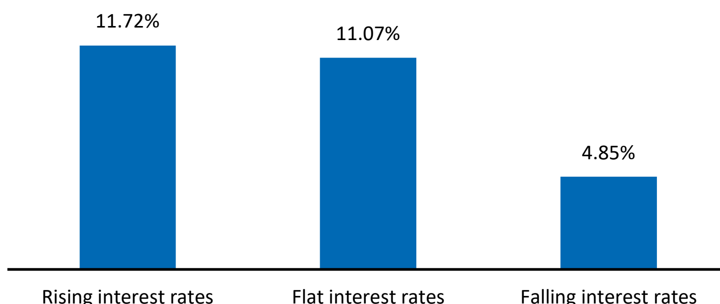
Of course, high yield bonds do not outperform equities over every period, especially since large-scale quantitative easing became the norm, which aggressively pushed up equity prices. However, when compared to equities, high yield bonds demonstrate an exceptionally attractive long-term risk-adjusted return profile.

Lower interest-rate risk

Many investors rightly worry about the sensitivity of their fixed income assets to rising interest rates (duration). However, since most of the coupon return in high yield is comprised of credit spread, high yield typically does well during these periods. Interest rates generally rise in periods of economic strength, environments which are beneficial for corporate profitability and overall corporate health, which in turn is beneficial for credit spreads and therefore bond prices. As such, spread tightening can more than offset the impact of rising interest rates on high yield bond performance.

Historically, the generous credit spread offered by high yield bonds has more than compensated for default losses. As active managers, we seek to avoid significant capital losses and capture the full benefit of the credit-spread premium. Even if prices do fall, however, credit spreads provide a cushion against downside losses. If a bond falls in price, but offers an attractive coupon, investors can recover that loss quickly thanks to the income return offsetting the capital loss. Of course, coupons have been falling due to low government bond yields and relatively tight credit spreads. This makes downside protection through capital preservation (achieved through stock selection) even more important.

Exhibit 4: Average annual returns of high yield bonds in various interest-rate environments



Source: Aegon AM, Bloomberg and ICE BofA. Data provided is for illustrative purposes only. The data provided consists of 12 month rolling return periods from 31 July 2002 to 30 June 2022, totaling 228 periods included in the 12-month rolling calculation. Out of the 228, 97 periods were characterized as falling, 52 periods were characterized as flat, and 79 were characterized as rising. Falling periods are described as when the US Treasury bellwether 10-year yield fell more than 0.25% since the last period. Rising periods were when the 10-year yield increased more than 0.25% since the last rolling period. Flat periods are described as when the 10-year yield did not increase or decrease by 0.25% since the last period. The returns reference the Bloomberg US Corporate High Yield Index.

Diversification benefits

High yield can generate an attractive income return thanks to its generous credit spread over government bonds. The coupon earned by holding a bond is composed of two elements:

1. The underlying government bond interest rate, also known as the risk-free rate; and
2. The credit spread over government bonds that investors receive as compensation for accepting the credit risk of the underlying company.

Compared to investment-grade bonds, the spread component of the income return in high yield bonds is much greater. This makes high yield bonds much less sensitive to movements in the underlying government bond market. Taking the BofA US High Yield index as an example, Exhibit 5 shows that it is negatively correlated to US Treasuries - whereas US Investment Grade has moved very closely with underlying government bonds. This negative correlation with government bonds is a clear benefit during times of US Treasury market sell-offs.

Exhibit 5: Five-year correlations between high yield and other assets

	US High Yield	1-10 Year US Treasuries	1-10 Year US Investment Grade	S&P 500	Russell 2000
US High Yield	**1.00**				
1-10 year US Treasuries	**-0.38**	1.00			
1-10 year US Investment Grade	**0.76**	0.15	1.00		
S&P 500	**0.78**	-0.45	0.51	1.00	
Russell 2000	**0.77**	-0.54	0.46	0.91	1.00

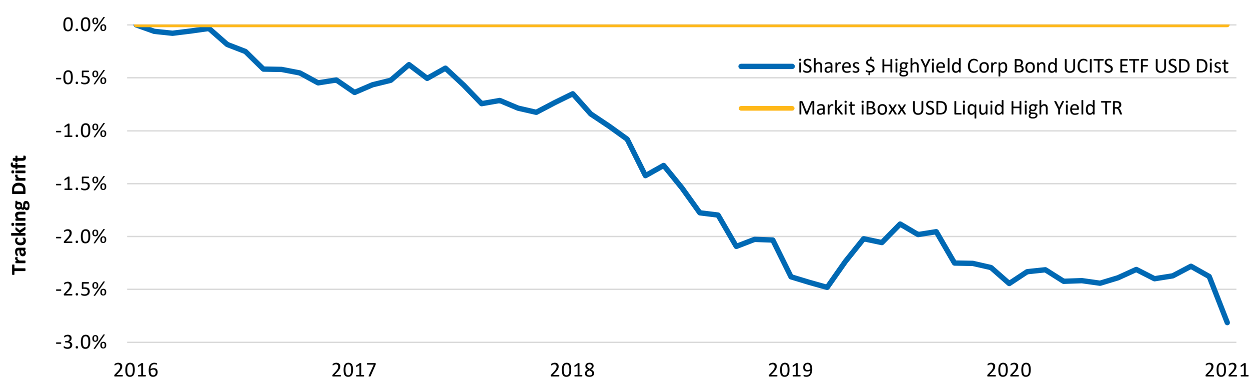
Source: Bloomberg, BofA, 5-year correlation as at 31 December 2021. Indices are ICE BofA US High Yield; ICE BofA 1-10 Year US Corporate; ICE BofA 1-10 Year US Treasury; S&P 500 Total Return; Russell 2000. USD, Weekly.

The problem with passive investing in high yield

We believe that index-tracking is a sub-optimal way to invest in high yield bonds. Debt indices are weighted by debt outstanding, so by tracking the benchmark you essentially allocate most of your portfolio to the most indebted companies. Although many indices are capped at a maximum issuer weight of 2%, indices must still take what they are given by the market. This was demonstrated by the large increases in index exposure to companies about to enter material financial distress before the dotcom and energy crises.

There is also a challenge around replication. Unlike equities, passive fixed income does not even attempt to track 'the market'. ETFs set their benchmarks as liquid sub-sets of the broader high yield universe. The iBoxx $ Liquid High Yield index has around half the number of bonds as the ICE BofA US High Yield Index and the composition of the index is different in terms of ratings and sectors. Exhibit 6 shows an ETF which has consistently underperformed its own index. While the index benefits from perfect liquidity and access to new issues, in a practical sense it is un-investable.

Exhibit 6: The underperformance of high yield ETFs compared to their own index



Source: Lipper as at 31 December 2021. Performance of representative ETF relative to relevant index.

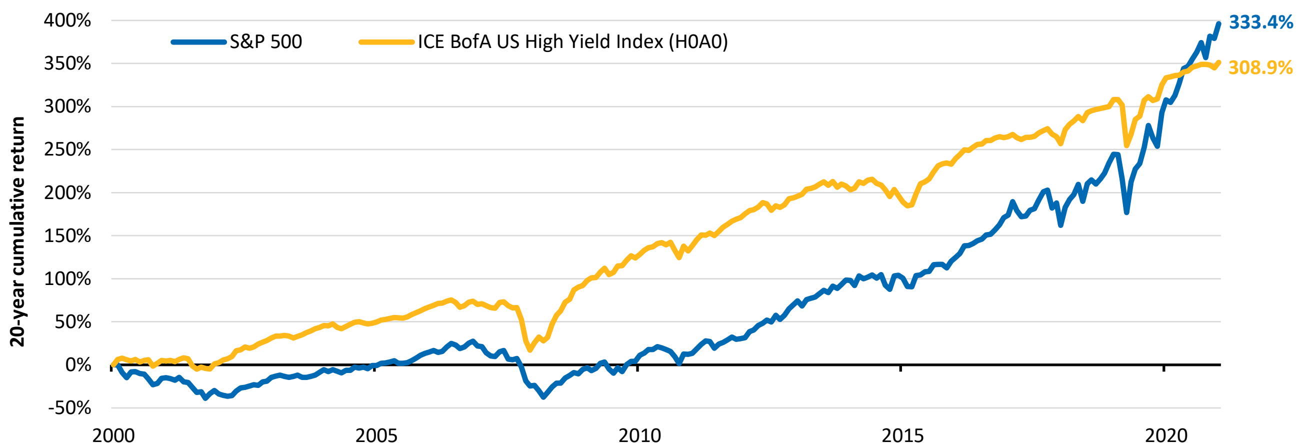
High yield or equities? Or both?

The performance of US high yield has compared well to the S&P 500 for much of the past 20 years, as shown in Exhibit 7. Of course, if you look only at the period following the Global Financial Crisis, then equities have outperformed, as quantitative easing and falling interest rates have supported high valuations.

The constrained capital upside in high yield is both a blessing and a curse. It is a blessing because the call constraint that mathematically limits valuations means that high yield rarely becomes overvalued in the same manner as equities. It is a curse because in periods such as the one we are in now, where QE has aggressively pushed valuations to their limits and where low interest rates make discounting future cash flows yield massive valuations, equities perform extremely well.

Unlike high yield, equities have theoretically infinite upside; it depends where and when the market breaks. This is partly why equities outperformed in a post-crisis world. High yield, however, has an extremely powerful long-term track record and current monetary policy does not diminish the attractiveness of the asset class relative to equities.

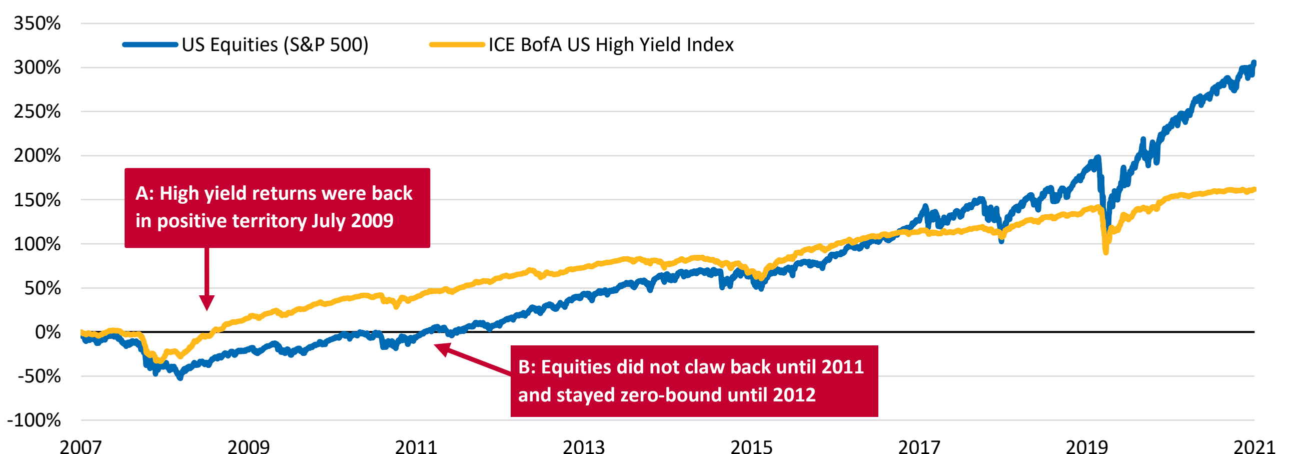
Exhibit 7: 20-year cumulative performance of US high yield and US large-cap equities



Source: Bloomberg, BofA, from 31 December 2000 to 31 December 2021.

During the Global Financial Crisis both equities and high yield bonds suffered losses, but as the first period [A] highlighted in Exhibit 8 shows, high yield experienced a significantly lower drawdown and began its recovery significantly earlier than equities. US high yield bottomed in November 2008, while equities bottomed in February 2009. Significantly, high yield was back to a positive return by July 2009 [A]. Equities did not claw back to net positive territory until 2011 [B] and even then, they range-traded around zero total return until 2012.

Exhibit 8: High yield exhibits drawdown protection relative to equities



Source: Bloomberg, BofA, 31 December 2021.

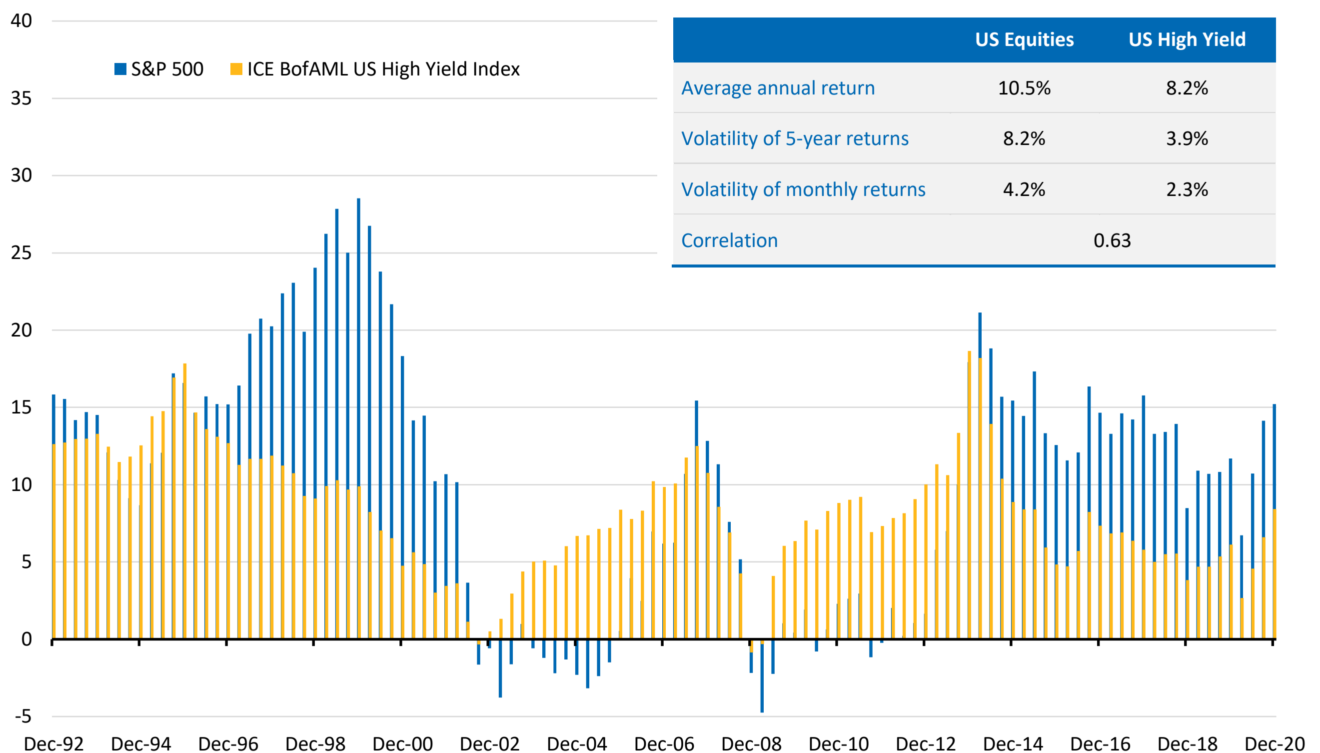
The way in which high yield debt is structured allows the asset class to benefit from this effective 'snapback' quality. Traditional high yield bonds have a defined legal and final maturity (typically with an underlying call schedule that can shorten, but not extend the life of the bond), while equity is permanent capital. In other words, unless the issuer defaults on its obligations or restructures its debt in another manner, bonds will pull back to par as maturity approaches.

The perpetual nature of equity means that it can, in theory, stay cheap forever, but a capped maturity profile means this is not the case with high yield debt. Clearly, the underlying credit work must be sound in order to benefit, but the structure of the market aids in its recovery from sell offs.

In practice, what does the 'snapback' characteristic mean? It means that market timing is not as significant in high yield as one might think. The 'snapback' qualities of the asset class help put investors' minds at ease; even if you buy at the top (such as during the Global Financial Crisis) or at tight valuations (late 2018) the market tends to return to positive territory very quickly.

As outlined in Exhibit 9, high yield offers material diversification and return-enhancing qualities in an investor's risk budget. We believe it deserves a place in portfolios alongside both other fixed income assets and equities. As illustrated below, high yield tends to outperform in sell offs and provides attractive returns with lower volatility.

Exhibit 9: US equities vs US high yield 5-year annualised returns (%)



	US Equities	US High Yield
Average annual return	10.5%	8.2%
Volatility of 5-year returns	8.2%	3.9%
Volatility of monthly returns	4.2%	2.3%
Correlation	0.63	

Source: Bloomberg as at 31 December 2021. Volatility statistics are not annualised.

Our approach to high yield

We believe that high yield deserves its own allocation in any diversified portfolio, with its unique characteristics placing it somewhere between an equity and core fixed income allocation. Tactically, investors can also utilise high yield to de-risk their equity position, or increase risk in their fixed income position, or treat high yield as a separate asset class.

We construct our high yield portfolios using fundamentally driven, bottom-up credit research, combined with a top-down framework. Our investment approach is dynamic and nimble. We are active, high conviction managers seeking to exploit market opportunities and inefficiencies.

Key tenets of our style include:

	High-conviction security selection	We manage high-conviction portfolios of our best investment ideas. Our primary focus is security selection, informed by bottom-up credit research and top-down insights. We rely on deep, fundamental credit analysis to build high-conviction portfolios of best ideas from the bottom up, complemented by a structured top-down process that governs overall risk.
	Flexible mandate	We invest only where we see value. Our mandate is flexible; if we do not like something, we choose not to own it rather than underweight it. We believe this flexible and active approach helps us to maximize the opportunity set and avoids unintended constraints imposed by a benchmark. By constructing a strategy that is significantly different to the index, we can generate returns that are meaningfully different to our peers and global high yield indices as we aim to generate value for our clients.
	Dynamic asset allocation	We embrace an active and dynamic approach to allocating to regions, ratings and sectors. With the support of our deeply resourced global research teams, we aim to exploit inefficiencies and navigate dislocations.
	Disciplined and risk-aware	Maintaining investment discipline is central to our style. We will not indiscriminately add risk and instead seek to balance risk and reward. Our objective of generating strong risk-adjusted returns means that, rather than chasing income without regard for capital, we aim to preserve capital within the confines of the high yield universe. Using a disciplined process, we focus on taking the right amount of risk at the right time to deliver consistently strong risk-adjusted returns for our investors.

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