CEF Weekly Article

Why Do You Own High-Yield Bonds?

Investors should assess why they own high-yield bonds and what their expectations are going forward.

Sumit Desai, CFA
Fund Analyst
sumit.desai@morningstar.com
+1 (312) 696-6049

Cara Esser
Closed-End Fund Strategist
cara.esser@morningstar.com
+1 (312) 696-6395

The high-yield market was rattled last week causing a $6.5 billion outflow out of high-yield funds and exchange-traded funds for the week ended Aug. 6. This brought a four-week streak of net redemptions totaling $12.5 billion. The massive outflows followed months of commentary suggesting the high-yield market was showing signs of froth and highlighting the risks to this sector after a multiyear bull run. It'll be interesting to see whether these outflows continue or whether investors waiting on the sidelines will now jump back into the fray given slightly higher yields following the sell-off.

It's worth it to look at what led to this scenario and what to expect going forward. High-yield bonds have historically shown a higher correlation to equities than bonds. In fact, over the past five years ended July 31, 2014, the average fund in the high-yield bond category returned an annualized 10.6%, compared with 16.6% for the S&P 500 and 4.6% for the Barclays U.S. Aggregate Bond Index. Strong investor interest in high-yield bonds pushed high-yield spreads over Treasuries', to near all-time lows. The average spread for the Bank of America High Yield Master II Index was around 420 basis points as of Friday, Aug. 8, 2014, versus a historical average around 590 basis points. These low spreads mean that investors aren't getting paid much to take on the risks associated with high-yield bonds compared with relatively risk-free government bonds.

Several factors have driven these results. Investors have grown confident in corporate balance sheets following the financial crisis, and issuers of high-yield bonds are currently experiencing default rates near 2%, well below the historical average of 4%. Default rates were even lower earlier this year, before the widely expected bankruptcy of TXU, one of the largest issuers of high-yield bonds and bank loans. For context, default rates were near 10% following the 2008 financial crisis.

It's also possible that investors who moved into this category over the past several years did so in order to generate additional income and total return than could be realized in more-traditional fixed-income categories such as intermediate-term bonds. With default rates relatively benign and corporate balance sheets strong, investors were more comfortable taking credit risk over interest-rate risk.

It's difficult to predict how high-yield bonds will perform in the short term, but trying to understand best- and worst-case scenarios can help investors manage expectations appropriately. Under a best-case scenario for the bonds, corporate fundamentals stay strong and rates stay low. In this environment, investors can likely expect to continue earning steady income off their underlying high-yield holdings. Even under this optimistic outlook, it's highly unlikely that these investments would realize much capital appreciation though, given little room for spreads to continue tightening even after the early-August sell-off.

Several events could lead to a much less optimistic outcome for these investments. An unexpected deterioration in credit quality or a sharp and unanticipated rise in interest rates would possibly cause a flight to safety, especially if higher yields elsewhere make the trade-off for holding high-yield bonds less appealing. Another concern is that a sharp sell-off would trigger liquidity concerns. As money flowed into this space, we've observed some fund managers willing to reach for yield by taking on increasingly illiquid (but higher-yielding) bonds that would be difficult to sell if investors flock en masse. High-yield fund investors should understand the risk tolerance of their fund managers and how returns have been achieved in the past. Under the "risk-on" environment of the past several years, the high-yield managers with the highest returns are often also the ones taking on the most risk.

Closed-end funds offer some distinct advantages over open-end funds in the high-yield category, but of course also offer a different set of risks. By nature, closed-end funds do not have to deal with flows in and out of their funds, and thus aren't forced to exit positions at inopportune times. For this reason, it makes more sense to own illiquid securities in a closed-end fund than open-end vehicles.

On the other hand, most high-yield closed end funds also utilize leverage, which adds a layer of volatility that unleveraged funds do not experience. Obviously, leverage can boost returns in positive markets, but also amplify losses in downturns.

The early-August sell-off has caused discounts for some high-yield CEFs to widen, creating opportunities for those investors willing to take on the risks associate with the space. Below is a table of the eight cheapest high-yield CEFs ranked by their three-year Z-statistic. Caveat emptor though, as wide discounts will not necessarily help investors outperform if underlying NAV values continue to decline.