



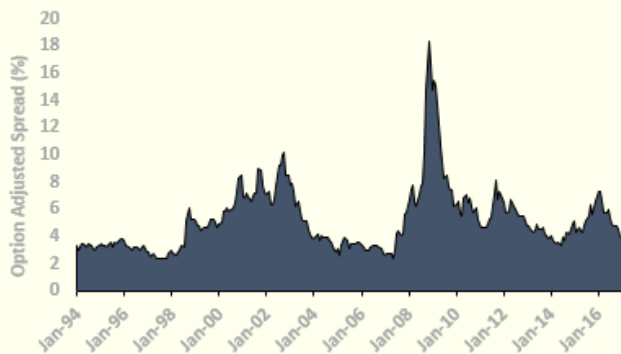
March 7th, 2017 | Scott Carmack (Portfolio Manager)

## BUY YIELD OR BYE YIELD?

### HIGH YIELD HAS BEEN HOT OVER THE LAST YEAR

Early 2016 was a horrid time for high yield. Commodity price crashes triggered a huge sell-off in speculative grade credits in related industries. Meanwhile, weak manufacturing data and a stronger dollar, exacerbated by potential rate hikes, incited recessionary fears in the United States. However, since February, the High Yield market has been on a tear as those fears proved to be overstated. The trailing one-year return for high yield as of February 28, 2017, was 21.8% as measured by the Barclays Corporate High Yield Total Return Index. The Barclays High Yield Option Adjusted Spread Index is now probing decade lows.

#### High Yield Spread



Source: Barclays Corporate High Yield OAS Index

Past Performance is not indicative of future results; investors cannot invest directly in an index.

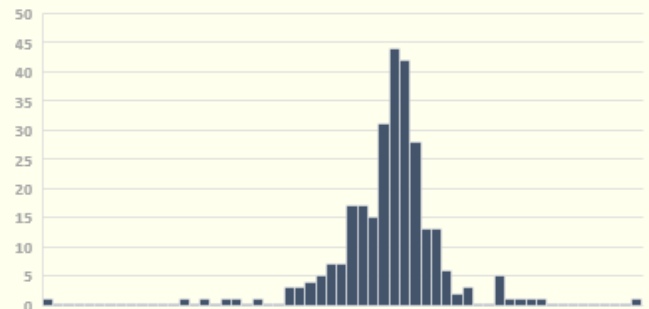
After the torrid run in high yield, does the asset class still represent value?

### HIGH YIELD RETURNS ARE SKEWED

High Yield is a unique asset class. Like many fixed income assets, it suffers from an asymmetric risk/reward profile. Ultimately, the potential gain for any high yield bond is the return of its principle and the accumulation of coupon payments. Unlike equities, its income stream cannot increase overtime. Meanwhile, the risk of default means that there is always the potential for its value to go to zero. It comes as no

surprise that high yield's return profile is not a normal distribution—it suffers from negative skew.

#### High Yield Monthly Return Distribution



Source: Barclays U.S. Corporate High Yield Total Return Index (1994-2017)

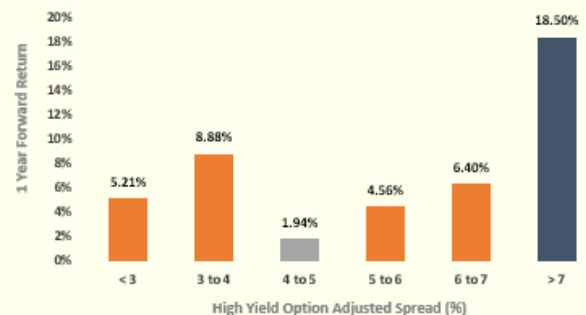
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When fundamentals or valuations support the high yield market, its returns look normal. However, when default rates are expected to spike, the asset class can have substantial losses.

### CURRENT SPREADS INDICATE THAT HIGH YIELD IS IN ITS SWEET SPOT

The chart below shows the average one-year forward returns for the Barclays Corporate High Yield Bond Index based on its spread to treasuries.

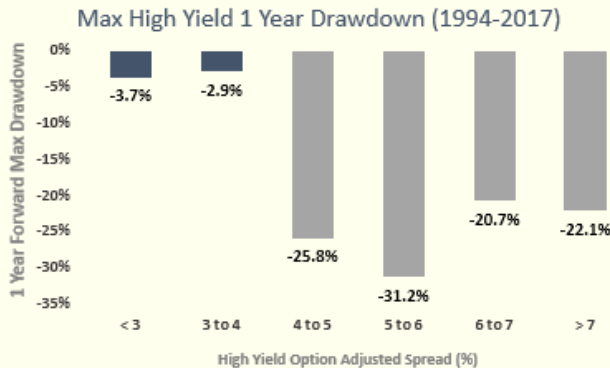
#### High Yield 1 year average returns (1994-2017)



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The current high yield spread over treasuries is 344 bps. Historically, that spread has implied the second highest 12 month return at 8.88%. Perhaps even more curious is that the maximum twelve-month drawdown for high yield at this spread level is the lowest among all levels.



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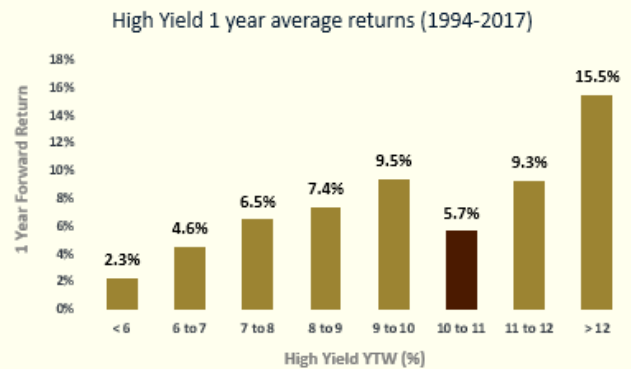
This data may surprise many who expect future performance to deteriorate as valuations move higher. However, it speaks to the nature of high yield and its asymmetric risk. When spreads are particularly tight (as they are now), it is indicative of an improving economic backdrop where default rates are likely to remain low. Such an economic environment takes time to reverse, and, thus, it is unlikely that high yield will come “unhinged” over the next twelve months—if history is our guide. However, there is a spread level that has historically been exposed to such tail-risks (4-5%). At this level, average 12 month returns are the lowest across the spectrum, at only 1.94%. Granted, this does not include the data for the last eleven months since it has yet to produce one year returns. However, even if this data is extrapolated by annualizing the partial year returns (which is generous), the average 12 month returns only increase to 3.15%, still the lowest.

History would suggest that at the current spread level, high yield is likely to perform well over the next twelve months, and that the risk for significant drawdown is low. Spreads are historically low for a reason, and deleterious economic shifts take enough time to provide for a margin of safety. An incremental uptick in spreads to above the 4% level, however, may indicate that that time is running out, and high yield is more likely to experience the ugly side of its “skewed” distribution.

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## ABSOLUTE YIELDS FOR HIGH YIELD ARE IN UNCHARTERED TERRITORY

Before investors go running off and plugging their portfolio with CCC credits, there is another metric to consider—absolute yields. Historically, spreads have been an appropriate metric for analyzing value and potential return in the sector. However, given the low nominal treasury rates that provide the benchmark for these spreads, an alternative measure may be more prudent. Currently, the yield to worst (YTW) for the Barclays Corporate High Yield Index is 5.51%. Below are the average 12 month returns for high yield based on its starting nominal YTW.



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Average returns for the index when value is measured in yield rather than spread plummet drastically. At these levels, High Yield averages a meager 2.3% over the next twelve months. Moreover, all 20 months that registered YTW under 6% occurred in 2013 and 2014, so there is a shortage of data over market cycles.

From a spread perspective, high yield’s risk/return profile over the next year looks attractive. However, given low nominal yields, the sector’s risk assessment should no longer be limited to credit risk. Interest rate risk becomes a valid consideration. Historically, high yield has been an excellent asset class to own in a rising treasury rate environment. Higher coupons typically absorb interest rate increases through both carry and spread compression. However, while spreads may continue to tighten, they may not be able to tighten enough to offset rate increases.

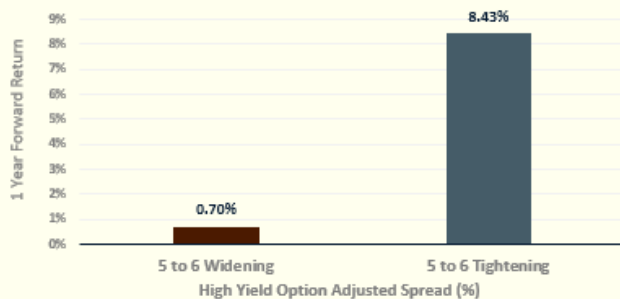
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## DO NOT CATCH A FALLING KNIFE IN HIGH YIELD

The “event horizon” for high yield spreads is in the 4-5% area. This is the level where high yield is still richly priced, but economic fundamentals are not strong enough to entirely price out a spike in the default rate, or a potential recession. It is the level at which high yield is the most vulnerable to a fundamental change in the economic environment.

Given the very nature of high yield, and that the lack of liquidity can hurt price discovery, it is a prudent strategy for investors to resist the urge to buy dips. For example, the one-year average return for high yield when spreads are between 5 and 6% is 4.56%. However, that performance is bifurcated by trend. In months where the spread has widened from the previous month, average returns are a paltry 0.7%. In months where the spread has tightened from the previous month, average returns are much higher (8.43%).

High Yield 1 year average returns when OAS is between 5 and 6%



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When the economic backdrop changes, the high yield sector faces numerous headwinds. Fundamentally, default rates spike and leverage metrics increase as cash flows dwindle. Just as important, however, are the technical issues that can emerge. Liquidity dries up, and there is a vacuum between where retail investors *were* finding value, and where distressed investors are willing to buy. History suggests that this vacuum exists between the 500-700 bps spread level.

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## CONCLUSION

High yield spreads are low, but they are low for a reason. History has shown that current spreads do well over the subsequent year with minimal drawdowns. However, high yield investors should consider the interest rate risk inherent

in high yield given low treasury yields. More importantly, any uptick in spreads from these levels should be taken as a warning sign and not a buying opportunity. The trend is your friend, until it changes. I can only find one instance where high yield spreads pierced 4% to the upside on a weekly basis and did not go to 6% within the next year (May 2005). Best to be a patient buyer the next time spreads breach 4%.

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