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Global high yield: The asset class for all seasons

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In this article, we look at the high Sharpe ratios, improvement in quality and low duration of global high yield corporate bonds and explain why we believe that this asset class, whether accessed as a singular mandate or through a broader global diversified credit allocation, could be a valuable addition to a DB pension scheme portfolio.

As advocates of global high yield bonds, we believe investor commitment to this part of the market should be reviewed and potentially revised, as it could form a valuable part of a scheme's overall allocation.

High yield has delivered superior risk-adjusted returns

Figure 1 shows the Sharpe ratios of bonds by rating category. Over the timeframes shown in Figure 1, we observe that high yield has demonstrated a superior risk-adjusted return relative to other generic bond asset classes and also compared favourably over longer periods to the main USA equity index. Yet, despite being the 'asset class for all seasons', direct allocation by UK DB pension schemes has been low.

Figure 1: Sharpe ratios

				High yield			
	US 5yr Treasury	US 10yr Treasury	US BBB rated credit	US BB credit	US B credit	US CCC credit	S&P 500 index
1yr	0.47	-0.15	2.36	2.92	2.83	3.08	2.18
3yr	1.04	0.73	0.85	0.99	0.74	0.27	0.64
5yr	0.51	0.32	0.95	1.25	1.19	1.3	0.85
10yr	0.76	0.64	0.99	1.39	1.11	0.92	0.79

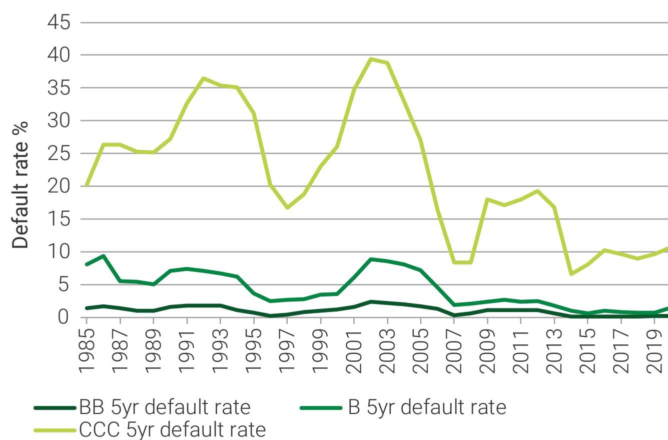
Source: Bloomberg, ICE BofAML and LGIM analysis as at 10 March 2021. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Under-allocation can be due to 'fear' of defaults. Yet defaults are priced into Figure 1, showing that they may not be as impactful as investors fear.

Improvement in quality

One of the areas that managers in this field may miss is that global high yield is not homogenous, but can be broken in to three distinct parts: BB, B and CCC. Investors must be discerning about which rating band they refer to, as each has very different characteristics. Figure 2 shows the five-year average default rate since 1985 of each of these rating bands and it is immediately apparent that the bulk of defaults are concentrated in the CCCs.

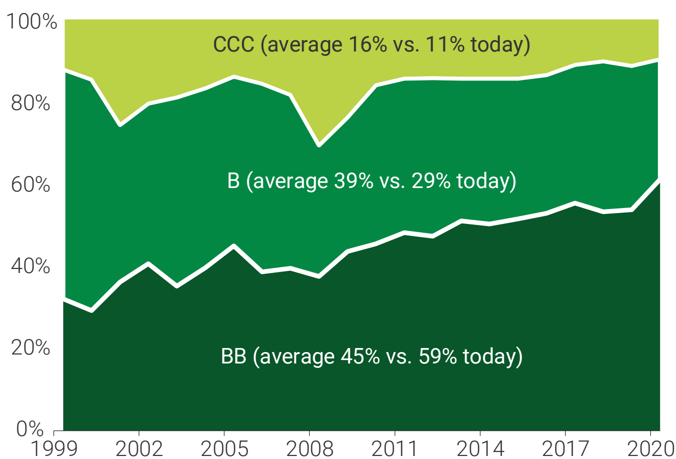
Figure 2: 5-year high yield default rates



Source: Moody's 2020, Default Study. Past performance is not a guide to the future.

If we then examine Figure 3, it is clear that the credit quality of the benchmark has been improving over time. When one looks at global high yield exposure, it is actually becoming increasingly difficult to find bonds within the shrinking CCC segment, which reduces the likely default experience of the universe.

Figure 3: Ratings breakdown of the high yield universe



Source: LGIM and Bank of America Merrill Lynch. Ratings breakdown as at 31 December 2020. Past performance is not a guide to the future.

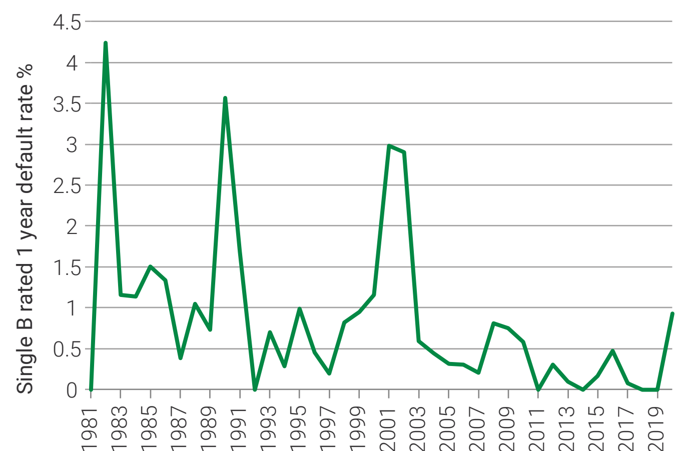
Figure 4: One-year average defaults rate since 1920

Rating	BB	B	CCC
One-year average (1920 - 2019)	1.0%	3.0%	10.0%

Source: Moody's 2020 Default Study, Annual issuer-weighted corporate default rates as at 31 December 2020. Past performance is not a guide to the future.

Global high yield defaults are also 'spiky'. If we look at the one-year default rates of B rated bonds over time, defaults rarely rise above the average.

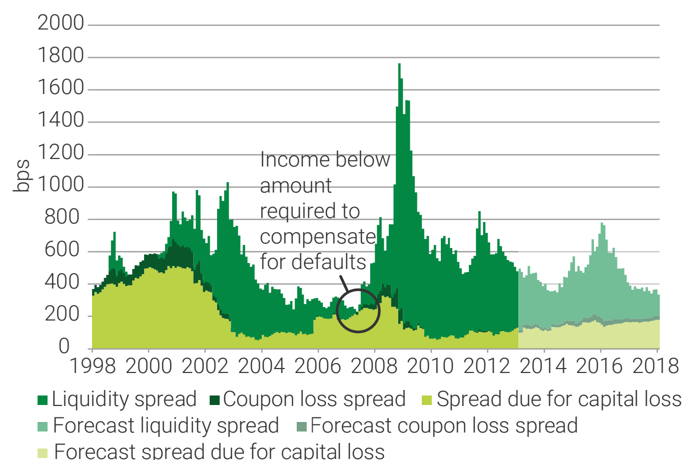
Figure 5: B rated 1-year default rate



Source: Moody's 2020, Default Study. Past performance is not a guide to the future.

What may surprise many is that if and when defaults do occur, investors have almost always been overcompensated for the risk: Figure 6 shows that for single B rated issues, only in one year was the income below the requirement to compensate for defaults. This is what supports the high Sharpe ratio.

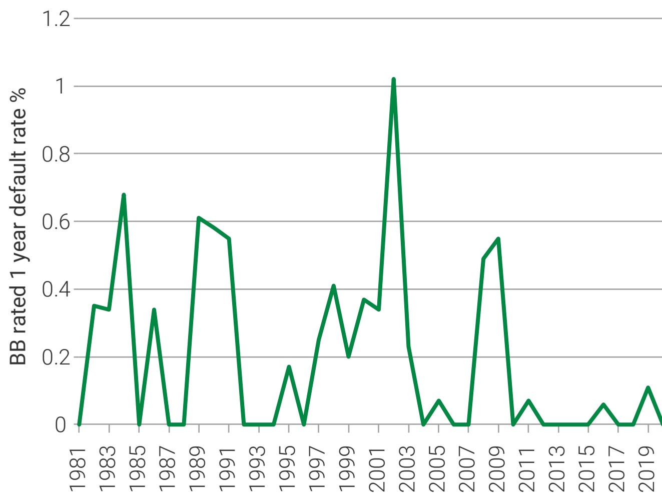
Figure 6: Compensation earned versus default loss for B rated bonds



Source: LGIM internal data, ICE BoAML indices (HUC1, HUC2, HUC3), Moody's default rates. Past performance is not a guide to the future. "Liquidity spread" is the proportion of overall spread attributable to liquidity, and so forth.

When one looks at BB rated bonds, this over-compensation becomes even more stark.

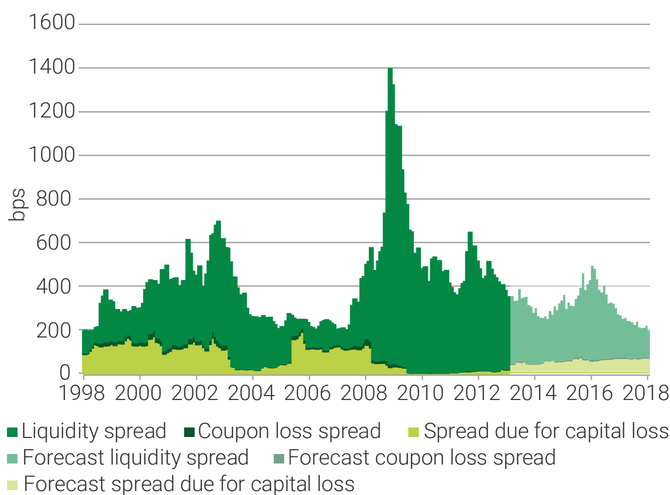
Figure 7: One-year default rates, BB



Source: Moody's 2020, Default Study. Past performance is not a guide to the future.

As demonstrated by the liquidity spread in Figure 8, which is consistently above 0, we believe these low default rates create an opportunity for investors to be overcompensated by owning BB. Even during the 2020 pandemic, default rates for this segment of the market stayed closer to 0% than 1%.

Figure 8: Compensation earned versus default loss for BB rated bonds



Source: LGIM internal data, ICE BoAML indices (HUC1, HUC2, HUC3), Moody's default rates. Past performance is not a guide to the future.

The analysis automatically prompts the question of how these opportunities can exist in an efficient market. The answer is: "regulators".

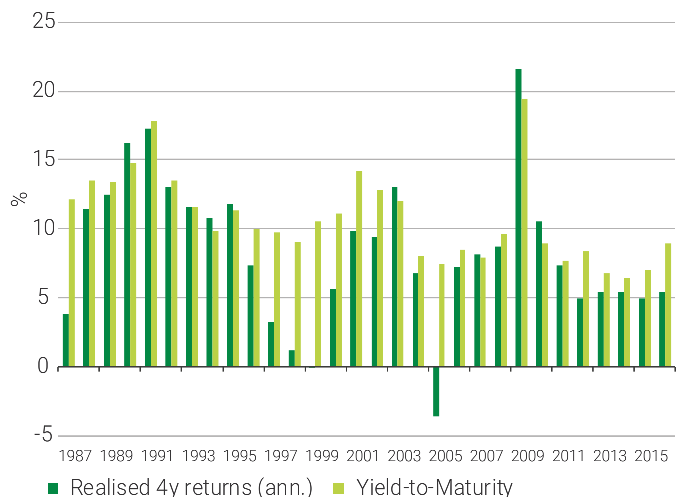
Banks and insurance companies normally find the cost of the capital required to be put aside to own global high yield bonds too prohibitive. Chatter about high default rates or notorious market participants normally supports the regulatory narrative. However, we believe this creates a persistent opportunity.

What return should an investor expect?

We believe with a strong recurring income and low correlation to other asset classes, with an integrated over-compensation, this may be appealing to pension scheme trustees.

When considering what returns might be at any point in time, we provide an approximate idea in Figure 9; we show four-year returns because the lifespan of high yield bonds is generally around four years. Mostly, over the four-year periods shown, the investor has earned something close to the yield on offer when the investment has been made.

Figure 9: Yield versus four-year returns



Source: Internal and Bank of America Merrill Lynch as at December 2019. Past performance is not a guide to the future. Statistics shown for ICE BofAML US High Yield Index (H0A0).

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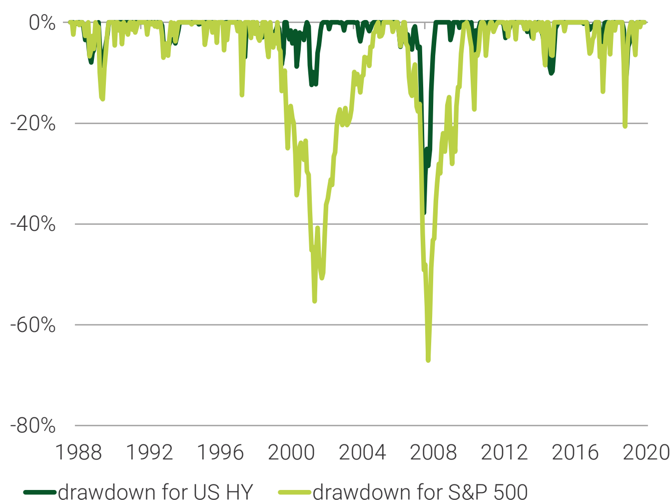
Analysis is based on a rolling four-year holding period commencing at each year end from 1986 where yield is measured at the start of the holding period. Returns (CAGR) are based on a holding period of four years from the beginning of each calendar year. Yield-to-maturity is based on the yield at the beginning of each calendar year (at the start of each holding period).

What about drawdowns?

Drawdowns can also be a further concern for investors. However, Figure 10 shows that, relative to equity, drawdowns in high yield are less frequent and less prolonged, and the asset class tends to bounce back quickly.

Figure 10: One-month cumulative drawdown and recovery for the S&P 500 and US high yield



Since 1988	>10% loss over 3mth period	Average recovery
US high yield	1.6% (6 times)	8 months (best 5, worst 10)
S&P 500	6.0% (23 times)	13 months (best 2, worst 44)

Source: ICE BofAML, Bloomberg and LGIM internal as of 30 April 2021. Drawdown is calculated using 1-month returns on a cumulative basis, resetting to 0 when cumulative loss is fully recovered and stays at 0 until drawdown begins again. Past performance is not a guide to the future.

As the table illustrates, only 1.6% of the time there has been more than a 10% loss over a 3-month period. We believe in order for an investor to avoid the bulk of the drawdown, they would have to be very timely and disinvest within two weeks of the start of the negative returns. Moreover, in order to regain the upside, they would then have to buy back ten weeks later. The relative rapid recovery of the asset class helps explain the strong Sharpe ratios illustrated earlier, and supports the idea that an allocation to this asset class should be a strategic one - unless the investor can not only call a rare market move, but can also act very quickly.

Duration

Most fixed income asset classes require a long duration to achieve a reasonable level of income. In high yield, however, the dominant factor is not interest rate but credit risk which, as established above, is relatively low, high yield tends to have a duration of only about four years, which is significantly shorter than the broad investment-grade fixed income market.

Figure 11: Relative duration of sterling investment grade credit, sterling government bonds and global high yield

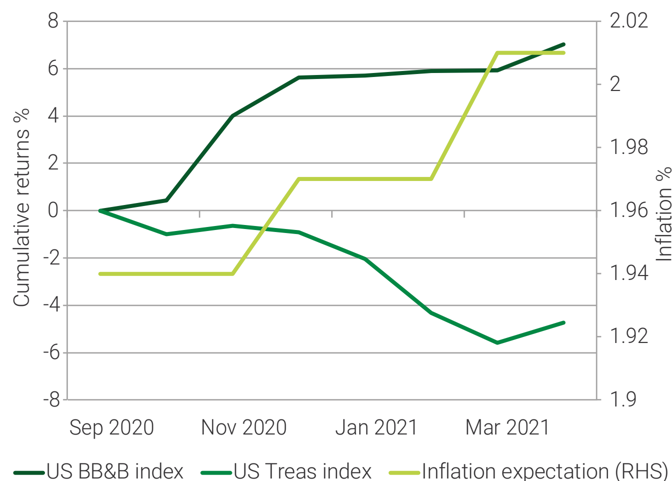
	£ IG credit	£ Government bonds	Global high yield
Duration	8.3	12.4	3.7

Source: ICE BAML as at April 2021. Past performance is not a guide to the future.

The low duration of global high yield is one of the reasons that the asset class recovers quicker after a market sell-off. Companies usually pay off their debts, except in the CCC segment. In a rising rates environment, high yield has the enviable reputation of generally having a sufficiently high enough income to protect against mark-to-market losses caused by interest rate moves.

As Figure 12 shows, high yield has in fact had a much lower correlation to these factors, due to its lower duration and higher income. This combination can be a preferred mix for providing resilience in an inflationary environment.

Figure 12: Return versus inflation



Source: ICE BAML US BB&B Index (H4UN), ICE BAML US Treas index (G0Q0), CIEFEC Index (US Federal Reserve Inflation expectation index), as at 30 April 2021. Past performance is not a guide to the future.

Summary

The innate characteristics of high yield create an asset class for all seasons that we believe has the potential to work well in most portfolios.

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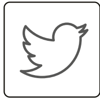

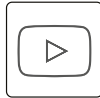

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