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The Case for High Yield

Uncorrelated returns and low volatility make this asset class attractive.

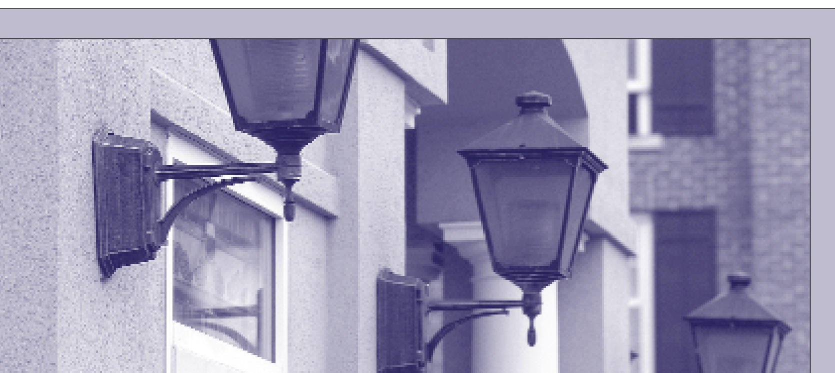
High yield bonds have provided some impressive returns over the long term, and they are particularly attractive today compared to historic valuations. These bonds have also yielded a superior return per unit of risk than treasury bills or stocks. Risk-adjusted returns and low correlation with traditional asset classes make them an important tool for diversification.

High yield bonds are corporate bonds that are considered non-investment grade as they are rated below BBB by the major rating agencies. These bonds are perceived to carry a high credit risk, and as a result they have higher interest rates than investment-grade bonds.

The U.S. high yield market has grown significantly over the past 20 years. In 1982, it totalled less than $50 billion. Today, it comprises about $900 billion and is expected to exceed the $1-trillion mark this year. This represents close to 20 per cent of the total corporate bond market.

Most of the market's growth has arisen out of new issues. But over the past 18 months, a significant portion has come from investment-grade bonds in the form of 'fallen angels.' This trend is expected to continue throughout the year. In addition, the market has gained significant breadth and is well represented across many industries, none of which make up a disproportionate part of the universe.

A major attribute of this asset class is its attractive risk-reward nature. Since 1985, high yield bonds have outperformed treasuries and captured close to two-thirds of the returns available in the stock market. As well, these bonds boast the lowest standard deviation and less than one-third the volatility of small-cap stocks. In fact, high yield bonds have the highest reward-to-variability ratio (Sharpe ratio) among all of these assets.



Low correlation

Another benefit of high yield bonds is their low correlation to other asset classes, which improves portfolio diversification. Since 1985, high yield bonds have had a correlation of 0.50 or less to investment-grade bonds and stocks, and only 0.21 to the 10-year treasury bill. Using an efficient frontier analysis, as high yield bonds are added to a portfolio comprised solely of investment-grade bonds, volatility decreases and returns increase, reaching a minimum level of volatility with a 30 per cent allocation.

Currently, high yield bonds appear to be undervalued. At the end of the third quarter of 2002, non-defaulted high yield bonds were offering interest rates of more than 10 per cent or 1000 basis points above government bonds, as measured by the Merrill Lynch High Yield Master II Index. This compares with an average historical spread of less than half that rate.

The last time high yield spreads were so wide was in early 1991 when the market was plagued by high inflation, high interest rates, a weak banking system and the demise of Drexel Burnham, the largest player in the asset class. The Gulf War was also taking place.

Current fundamentals are much healthier. From 1991 to 1993, annualized returns were well in excess of 20 per cent. Now, high risk premiums mean that high yield bond investors can earn double-digit returns over the next few years. As well, current high yields and low bond prices are already discounting most of the potential bad news in the market, providing downside protection if the economic outlook does indeed deteriorate.

Overall, high yield bonds are an attractive asset class with low volatility. They represent a high yield allocation that improves overall portfolio diversification and, based on historical valuation, they are presently undervalued. ■