

Opportunities in High-Yield

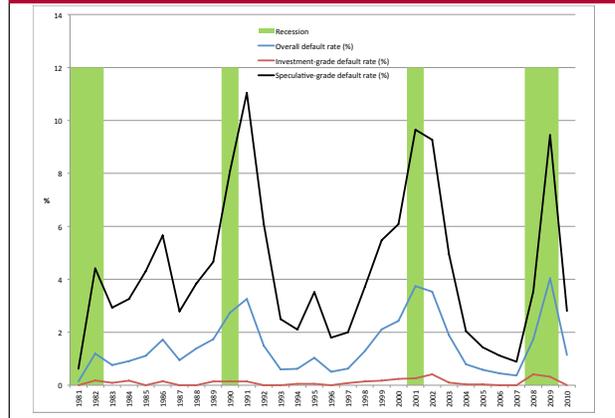
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The economic uncertainty in Europe and, to a lesser extent, in the United States has caused broad risk aversion in the financial markets. The purchase of high-yield bonds is a timely way to capitalize on this uncertainty. For an investor who is comfortable with the risk profile of owning equities and who has a need for income, high-yield bonds could be an appropriate addition to a diversified portfolio.

A high-yield bond is simply a bond that is issued by a company and, for a variety of reasons, carries a lower credit rating. The reasons may derive from the company's size, the industry in which it operates, customer concentration, regulatory risk, the company's leverage profile, and other factors. High-yield bonds are often characterized as having a risk component between that of investment-grade bonds and traditional stocks, meaning they perform well during an economic expansion, but can underperform when the economy is slowing. As seen in the following chart, during recessionary periods such as the early 90's, the tech bubble from '01-02, and the most recent financial crisis, high-yield (or speculative-grade) bonds have a higher rate of default because of the aforementioned reasons. They are thus perceived as riskier than investment-grade bonds, but often seen as safer than individual stocks because they rank higher than equity securities in the company's capital structure.

**Global Default Rates:
 Investment Grade Versus Speculative Grade**



Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®

With fixed income investments, the two largest components of return are income and price appreciation. Income speaks for itself as the coupon (interest rate) on the fixed income instrument. The price can appreciate or depreciate based on multiple factors. The two most notable factors are interest-rate movements in general and the credit quality of the issuer improving or deteriorating. We believe that opportunity exists in this second aspect. With the recent economic worries, the perception of the riskiness of high-yield bonds has grown dramatically. The following chart is one way to reflect the risk component of high-yield bonds. Specifically, it shows the amount of yield that high-yield bonds offer over

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U.S. Treasuries of equivalent maturity. Note that, from the beginning of the year to May, this ‘spread’ declined, indicating that the opportunity in these bonds was narrowing, primarily due to positive economic developments. Since this past summer, however, this spread has widened by over 3.00% as investors have shunned riskier investments such as stocks and high-yield bonds.



Source: Barclays Capital Live

At the current spread levels of 7.0–7.5%, JP Morgan estimates that the market is implying a 7.4% default rate for high-yield bonds going forward. This projection seems particularly pessimistic and, as indicated in the previous chart from Standard and Poor’s, is a level seen only in recessionary periods. Although we do not dismiss the probability of a recession, the fact remains that the bonds are effectively pricing in a recession, despite the fact that company balance sheets are in a better position than 2008, corporate margins and earnings are strong, leverage is back to pre-crisis levels, and cash balances are much greater than historical averages. For reference, Standard and Poor’s estimates that the default rate for speculative-grade corporate

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bonds in August 2011 was 2.0%, an improvement from 2.1% in July.

The opportunity with high-yield bonds is simply stated. The yield-to-maturity of the Barclays Capital U.S. High Yield Index is 8.5%. The Index as a whole is highly diversified, with hundreds of individual issuers that operate in a variety of different industries. By owning an index, the risk is minimized that any individual bond may hurt the performance in aggregate. Our particular vehicle, the SPDR Barclays Capital High Yield Bond ETF ‘JNK,’ has fewer holdings than the Index but correlates well nonetheless. Additionally, we believe that the economy and high-yield bond default rates will not be as severe as the current spread indicates. Thus, the spread on high-yield bonds has the potential to narrow, causing bond prices to rise.

Recall the other risk with fixed income investments, interest rate risk (or market risk). Bonds may underperform as interest rates rise (due, for example, to inflation). High-yield indices often have bonds with much shorter maturities, better positioning them for rising rates than other indices. Although their performance would suffer if rates rise, that negative impact could be offset by the aforementioned spread tightening that can occur as rising rates indicate the possibility of stronger than expected economic growth. The Barclays Capital U.S. High Yield Index has a duration of 4.5 years and, as such, is relatively better positioned for rising interest rates than many other Barclays fixed income indices.

Finally, the addition of high-yield bonds complements our current overweight in equities in two

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ways. First, it adds further diversification; many high-yield issuers, such as Weyerhaeuser, U.S. Steel, BE Aerospace, CF Industries, Chesapeake Energy, Sealed Air, and J.C. Penney, operate in a broad variety of industries. Second, as an asset that is more positively associated with economic growth than investment-grade bonds or U.S. Treasuries, high-yield bonds are an investment in a continuing recovery in the economy. As such, from a portfolio perspective, high-yield bonds sit comfortably between our equity and investment-grade bond allocations.

In summary, we believe that the current risk aversion in the financial markets has presented an opportunity to purchase a complementary asset class at an attractive price. Matched with our tactical overweight in equities and underweight in investment-grade bonds, high-yield bonds should help to produce favorable returns over the economic cycle.

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