

Understanding High Yield Investing: Risks and Strategies

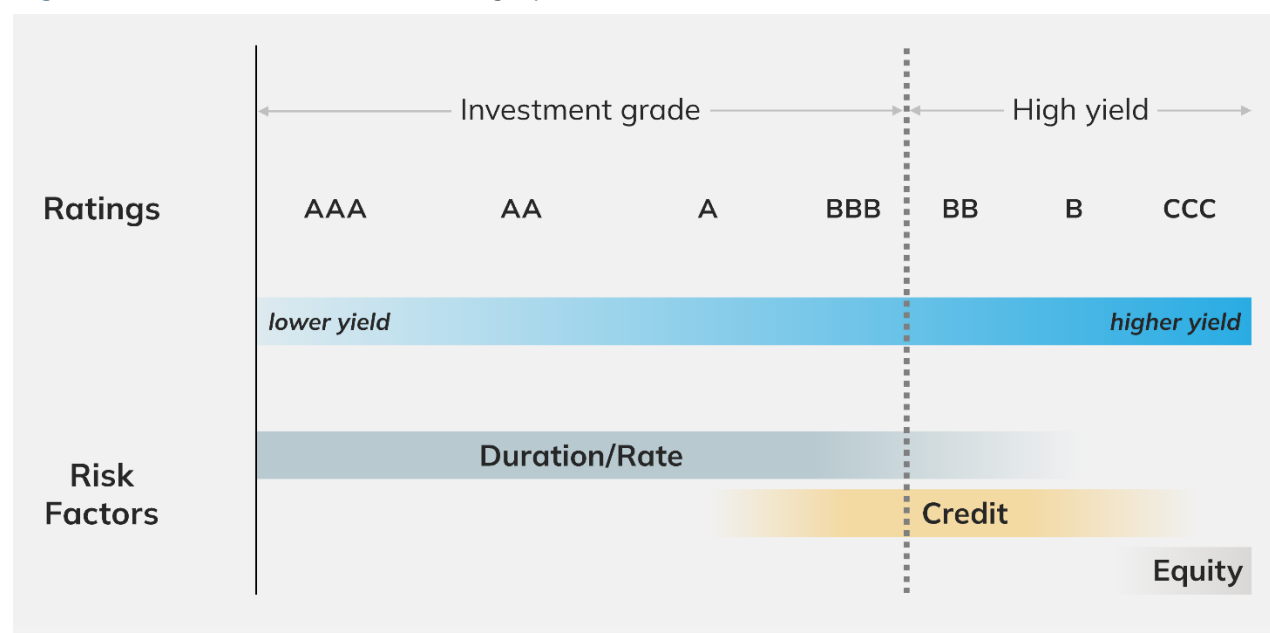
For many investors, high yield (“HY”) bonds present an appealing opportunity to enhance portfolio returns and diversify income sources. But historically, some investors have been deterred by its perceived higher risks thus missing out on the opportunities that this segment has provided.

In this publication, we will dissect the key risks associated with HY credit investing and discuss strategies to mitigate them. By understanding and effectively managing these risks, we hope investors can navigate this market segment with more confidence and enjoy the potential enhanced returns that it offers.

What is High Yield?

High yield bonds offer higher interest rates because they have lower credit ratings than investment-grade bonds. These bonds have credit ratings between BB and CCC.

Figure 1: Fixed Income Credit Rating Spectrum



At nearly US\$1.3 trillion, the U.S. High Yield market has a history of funding blue-chip American companies such as Ford, Tesla, Netflix, Toll Brothers, Alcoa, X (formerly known as Twitter), and Uber. Entire industries—including shale oil, gaming, airlines, telecoms, and healthcare – were launched and grown with assistance from the High Yield market.

As demonstrated in Figure 2, the high yield market has generated attractive returns over the long term, averaging about 6% annualized which is only about 0.95% lower than global equities (but with far lower volatility), and a significant enhancement over government and investment grade bonds.

Figure 2: Long Term Risk Return Comparison



Source: Morningstar Inc. Returns are daily and in local currency terms. High Yield is represented by the ICE BofA Global High Yield Index, Investment Grade is represented by the ICE BofA Global Corporate Index, Government is represented by the FTSE World Government Bond Index, and Global Equity is represented by the MSCI World Index.

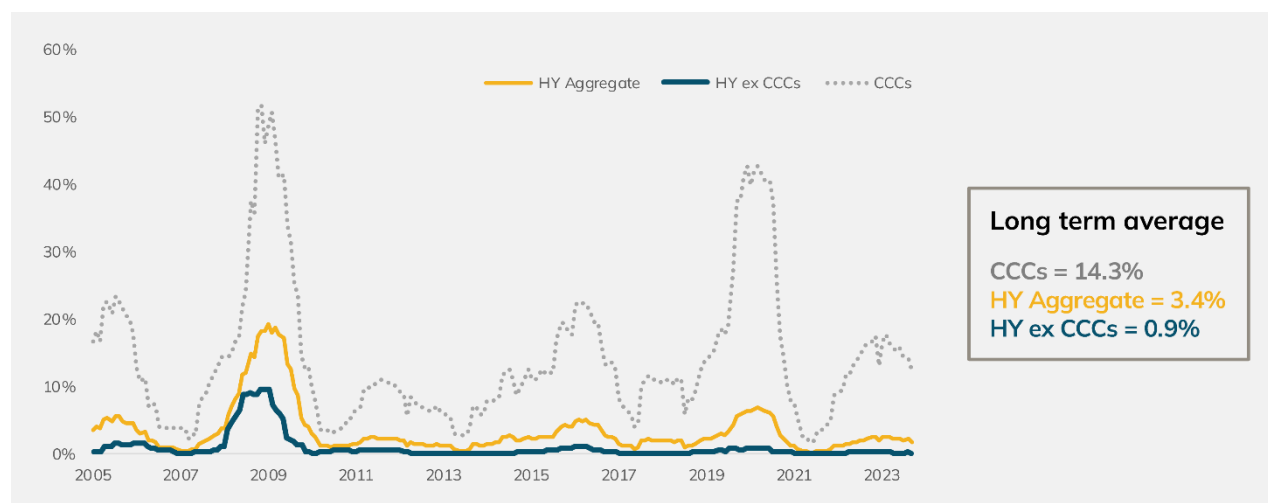
However, this strong performance does not come without risk. HY investors are primarily exposed to credit risk in the form of defaults and downgrades as well as spread widening risk due to market volatility. In the following sections, we will discuss these risks and how they can be reduced and/or mitigated.

Default Risk

Default risk refers to the probability that an issuer fails to make a contractually obligated payment on its debt. This is the biggest risk in HY investing, as such events may result in the total loss of your investment. At the market level, default risk is measured by the default rate, which is the proportion of principal that has defaulted over a 12-month period, expressed as a percentage of the initial market size.

Over the past 20 years, the HY market has had an average default rate of 3.4%. This rate moves up and down throughout the credit cycle, with recent spikes associated with major market events such as the 2008 financial crisis, the 2015 energy sector meltdown, and Covid in 2020. However, these peaks can be misleading when assessing the overall default risk of the high yield market.

Figure 3: High Yield Default Rate



Source: Bloomberg L.P. From Jan 1, 2005 to June 30, 2024.

A closer examination of the data reveals that CCC-rated bonds caused most of these defaults. CCC-rated bonds are the lowest tier within High Yield, and as illustrated by the grey dotted lines in Figure 3, they exhibit significantly higher default rates compared to B and BB rated bonds. When excluding CCC-rated bonds from the analysis, the default rate for the high yield sector drops dramatically to an average of only 0.9%, as represented by the dark blue line.

At Picton Mahoney Asset Management (PMAM), our fixed income team excludes CCC-rated bonds from consideration during the initial quantitative screening. We believe investors should not assume equity-like risk for bond-like returns. **By focusing on the higher-quality segment of HY, investors have the potential to benefit from enhanced returns while avoiding most of the default risk.**

Downgrade Risk

Credit ratings are determined by rating agencies, with the three biggest global agencies being Moody's, S&P Global Ratings, and Fitch Group. These agencies assess the creditworthiness of borrowers based on a wide spectrum of factors, but generally, downgrade risk arises when an issuer's fundamentals deteriorate.

This deterioration can result from poor operating performance or increased leverage. When a bond is downgraded, yields increase and prices fall to reflect the higher probability of default. Unlike other sources of risk, downgrade risk is largely idiosyncratic, meaning it is primarily driven by company-specific problems rather than overall market conditions.

Given the idiosyncratic nature of downgrade risk, it is crucial to adopt an active approach in high yield investing. To minimize exposure to downgrades, an active strategy can analyze credit fundamentals, gain company and industry insights from management meetings, and build forecasted cash flow models.

In addition to active management, adopting a long-short approach allows investors to not only avoid risky securities, but to capitalize on opportunities through short selling. In PMAM, we have strategies that identify rating agency downgrade and credit deterioration as investment themes that the team actively sources. **Detecting early warning signs of deterioration can allow investors to short sell those securities before the credit downgrade event occurs, thereby potentially generating a profit instead of merely avoiding a loss.**

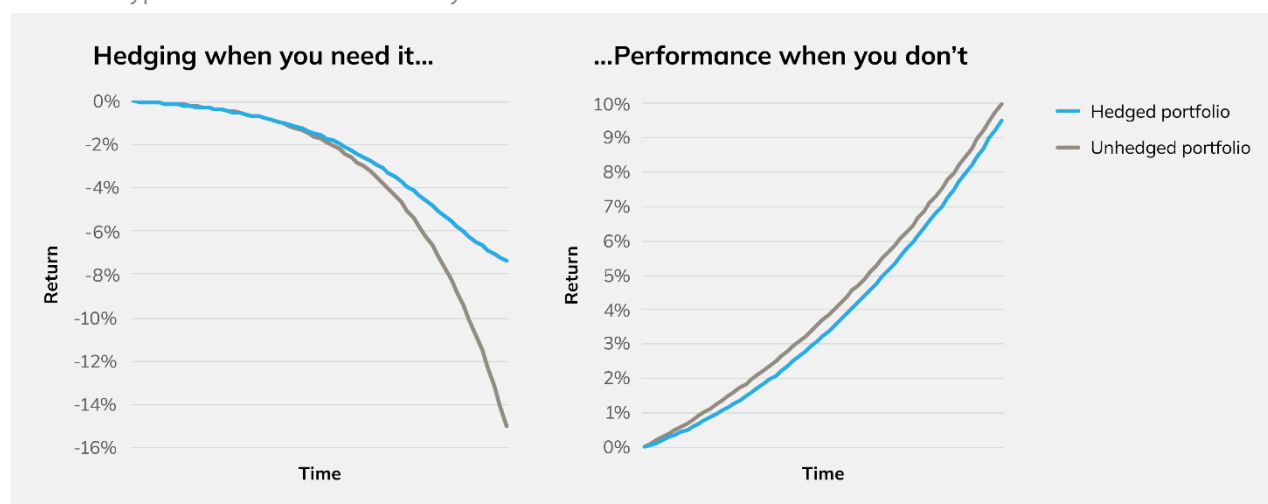
Spread Widening Risk

Spread widening risk refers to the risk that the difference between the yields of HY bonds and government bonds increases, leading to price declines. This risk can be driven by both company-specific issues and broader market sentiment. Spread widening caused by company-specific issues can be viewed similarly to downgrade risk, which we have discussed in the previous section. In this section, we will focus on market-driven spread widening risks.

Market-driven spread widenings can be caused by many factors, such as changes in sentiment, economic downturns, and increased market volatility. For investors overly exposed to market risk, it's like being in a small boat in the middle of a stormy ocean. Just as the boat can be tossed around by waves and strong winds, these investors may face significant volatility with every market shift.

Figure 4: Hypothetical Case Study – Option Hedging - Cost and Effect

Unhedged Portfolio is a hypothetical portfolio with 100% invested in HYG. Hedged portfolio is a hypothetical portfolio with 99.75% invested in HYG, hedged with 0.25% in 5% “out of the money” 3-month put options on HYG. This is of hypothetical return over 60 days .



For illustrative purposes only. “Hedging when you need it” scenario assumes the HYG declines by 15% over a 60-day period at the same constant rate each day. The “Performance when you don't” scenario assumes the HYG rises by 10% over a 60-day period at the same constant rate each day. There is no guarantee that a hedging strategy will be effective or achieve its intended effect. The use of derivatives or short selling carries several risks which may restrict a strategy in realizing its profits or limiting its losses, or which may cause a strategy to realize a loss. There may be additional costs and expenses associated with the use of derivatives and short selling in a hedging strategy. The portfolios above are hypothetical in nature, calculated using the historical returns of the underlying ETFs and related options with the intention to demonstrate the potential impact of hedging. Performance of actual portfolios can differ significantly. “Out the money” means the strike price of the put option is below the current market price of the underlying asset (HYG).

To help dampen the market volatility associated with HY bond investing, investors can pursue alternative strategies that employ hedging tools such as options. Figure 4 illustrates the impact of hedging in the broad HY market. The broad HY market is represented by the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG) which is the largest ETF in the HY segment. The key takeaway is that **while the use of hedging may slightly reduce portfolio returns during stable periods, it can significantly mitigate losses during major selloffs, providing investors with a much smoother ride over the long term.**

Conclusion

With attractive long-term returns, and today's elevated yields, the HY bond market is certainly worth considering for most investors. The challenge is to capture these returns while minimizing risk.

Taking an active, long-short, alternative approach when it comes to HY investing can help deliver this asymmetric return profile. Selecting the right fund manager is crucial when it comes to alternative strategies. Investors should prioritize strategies that have been rigorously tested in adverse conditions and thoroughly understand the underlying methodologies.

By carefully navigating the risks associated with high yield, investors can unlock the full potential of this market segment, therefore building more efficient portfolios.

Disclosure

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There is no guarantee that a hedging strategy will be effective or achieve its intended effect. The use of derivatives or short selling carries several risks which may restrict a strategy in realizing its profits, limiting its losses, or, which cause a strategy to realize or magnify losses. There may be additional costs and expenses associated with the use of derivatives and short selling in a hedging strategy.

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