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HIGH YIELD SECTOR ANALYSIS: WHY EXITING NOW MAY MAKE SENSE
By Jody Lurie, CFA, Director, Corporate Credit Analyst

The rally in high yield corporate bonds persisted through 2017, as credit spreads tightened on expectations that recent tax reform would add to economic optimism and improved credit quality for companies. As the downside risk outweighs the potential for upside reward, it is a worthwhile exercise for investors to reevaluate their holdings—both individual securities and funds—to take gains for those investments that are not long-term buy-and-hold positions. Although it is unclear when the next turnaround will occur, market liquidity challenges during volatile market environments promote acting in times of accommodative credit conditions, such as now.

The recent uptick in interest rates has not deterred yield-hunting investors from looking at high yield corporate bonds as an area of opportunity. The persistently low-rate environment has created an appetite for risk that normalized investing in high yield corporate bonds for investors who may otherwise not look at the asset class due to their risk tolerance. After all, the investor who did not participate in the rally in high yield corporates since the trough of the recession missed sizable returns that outweighed all other domestic fixed income asset classes. Only during the selloff in the energy and metals & mining space in 2015 did investors wake to the realization that default is a possible occurrence in this post-recession era.

The Case For High Yield
There are many arguments for why investing in high yield corporates continues to be a relevant strategy. First, positive economic data and optimism promoted the rally in equity valuations; coupled with easy credit markets for debt issuance, depict an environment that is open to higher risk investments. After all, if a company is nearing default in this environment, it has ample opportunity to refinance its capital structure to avoid or delay a formal bankruptcy process, as we saw with many energy firms. Secondly, recent tax reform, namely the 21% tax rate, will help companies’ bottom lines, so companies have the potential to improve their credit quality as another catalyst for credit spreads tightening. The offsetting factor in tax reform that affects many high yield firms is the interest expense deduction limits. Several leveraged up companies will be unable to deduct their full interest expense, negating some of the benefit seen with the lower corporate tax rate. Finally, Moody’s and S&P guided for shrinking default rates in 2018 with minimal headwinds in sight to alter such projections.

The Case Against High Yield
Nonetheless, the combination of (1) the rich prices found in most of the high yield corporate bond market, (2) the history of negative credit events taking the industry off-guard, and (3) the risk of market liquidity drastically reducing when sentiment reverses are all compelling arguments for why the time is ripe to reassess positions in the asset class and take profit in holdings that are not long-term investments. For individual investors, the ability to exit single security and fund positions when an asset class falls out of favor has become increasingly inhibited. Various thought leaders at the Fed, Brookings, and SEC have all indicated that market liquidity has not changed in normal market conditions during the post-recession era, but have hinted to it faltering during times of volatility and stress. Examples include the summer 2011 US ratings downgrade by S&P, the June 2013 “rate shock” after former Fed Chair Bernanke’s comments, and most notably the 2015 energy rout. These few examples show how quickly the market can shift such that individual investors are unable to reassess positions, but rather must wait out the volatility at the risk of losing principal along with gains from the prior rally in the asset class.

On a fundamental basis, other indications that the high yield space may be less attractive than on the surface include the rise in the average company’s debt and leverage, which, per S&P, hit record levels recently. The ratings agency noted in an October 2017 report that particularly companies at the lower end of the ratings spectrum are “as vulnerable to downgrades and defaults as they were in the run-up to the 2007-2008 global financial crisis.” Further, the rise in bonds and loans with more favorable structures for issuers (e.g. covenant-lite) means reduced protection for investors during a restructuring event. (It is also an indication of how yield-hungry investors have become.) At this juncture, we do not suggest a mass exodus from the asset class, but a more prudent consideration of high yield corporate bond positions with goals of limiting exposure to moderate levels in advance of additional uncertainty over the next 12-18 months.

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Reviewing the Upside versus the Downside

What are the potential upsides and downsides for the high yield corporate space? In October 2014, we attempted to answer the question by reviewing historical spread levels, identifying periods of the tightest credit spreads (June 2006 to June 2007) and periods of widening credit spreads (2002). Note that we did not pick the 2008-2009 recession given the severity in movement, but couch the discussion with the potential for even greater downside than what is depicted in our analysis below.

In our base case, we assume no change to credit spreads, relatively low levels of default and expected loss rates, and a year of performance similar to that which we saw in 2017. In this scenario, the credit cycle does not change too significantly and no “black swan” event shifts views of risk assets. In such a situation, due to a flatter yield curve, the base case return is greater for the lower end of the ratings spectrum than during our 2014 exercise. In this scenario, double B to triple C offer 4.8% to 5.4% returns, as the additional risk-taking adds value in a flat yield curve, low volatility environment.

In our upside case, we assume credit spreads narrow to June 2006-June 2007 levels, as default rates move to the lows of that period, and high yield remains a preferred part of the market in which to invest. A lack of alternatives and adequate supply to meet demand would contribute to this sentiment. In such an instance, the lowest part of the ratings spectrum offers the highest return, as demonstrated by the 14.4% for triple C versus the 6.0% for double B.

In our downside case, credit spreads widen and default rates tick up to levels seen in 2002. High yield falls out of favor as the market enters the down part of the credit cycle, in which access to debt capital is more limited and a flight-to-quality ensues. In such a scenario, the clear underperformer is the triple C category, with -29.2% total return, while double and single B categories are more modest in comparison due to reduced risk of default and better relative financial profiles.

In the above analysis, assumptions play an important part in the results, including the potential direction of spreads based on historical levels. Altering the expected loss rates factored in our calculations meaningfully changes the total returns of each high yield class. Further, the shape of the yield curve is a determining factor in relative attractiveness of high yield over other asset class. Steps taken by the Federal Reserve and other central banks should not be overlooked in terms of their effects on investors’ sentiment towards high yield corporate bonds over other asset classes.

### Possible Scenarios of Total Returns Illustrated

<table>
<thead>
<tr>
<th>Total Return</th>
<th>All HY</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base Case</strong></td>
<td>3.4%</td>
<td>4.8%</td>
<td>5.4%</td>
<td>5.4%</td>
</tr>
<tr>
<td><strong>Upside Case</strong></td>
<td>7.7%</td>
<td>6.0%</td>
<td>8.5%</td>
<td>14.4%</td>
</tr>
<tr>
<td><strong>Downside Case</strong></td>
<td>-12.1%</td>
<td>-7.3%</td>
<td>-8.9%</td>
<td>-29.2%</td>
</tr>
</tbody>
</table>

Source: Janney ISG; Citi/LSE Yield Book YTW, OAS, and other data; Moody’s default and recovery data; “All HY” includes below triple C, pulling down base case returns; expected loss based on assumed 60% recovery rate on historical default rates, upside based on Jun 2006-Jun 2007 spreads, and downside case based on Jan 2002-Jan 2003 spreads.

Note: excluded from the analysis is the below triple C territory, for which returns are lower in the base case and skew the “All HY” category vs specific ratings categories. Further, all of our scenarios rely heavily on recovery rate assumptions, which would reduce returns if we were to assume a lower recovery rate.

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**The Fund Investor**

The investor that has opted for funds over individual high yield corporate bond securities has benefited from a diversified exposure to the asset class with a more passive approach towards investing. That said, fund holdings should not be ignored in the discussion of portfolio review and rebalancing to reduce high yield corporate bond holdings. Some investors may opt for smaller percentages of their portfolio represented by high yield corporates, while other may look to exit the asset class completely.

The two largest high yield corporate bond ETFs, JNK and HYG, have seen significant growth in total assets: JNK to $10B from $3B since the start of 2010 and HY to $16B from $5B during the same timeframe. Both ETFs trade below their peak NAVs recorded in 2007. Like the high yield index, for which credit spreads have further to tighten, JNK and HYG’s net asset values could theoretically rise to these heights, but they could fall to the 2008-2009 lows, as well. For both, we see the erosion in value as more likely to surpass the possible gain, given the limited upside potential in the underlying bond assets, though we note how close to the midpoint JNK’s NAV is currently.

### Example of Multi-Asset Funds with Notable High Yield Exposure

<table>
<thead>
<tr>
<th>Fund</th>
<th>% High Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franklin Income</td>
<td>34%</td>
</tr>
<tr>
<td>Principal Global Diversified Income</td>
<td>28%</td>
</tr>
<tr>
<td>JPMorgan Income Builder</td>
<td>25%</td>
</tr>
</tbody>
</table>

Source: Janney ISG & Wealth Management; Bloomberg

Apart from funds that are solely invested in high yield corporates, investors should review their positions in multi-asset funds, as some of these holdings may overexpose the investor to high yield corporates unknowingly. For example, an investor may have 20% exposure in high yield via various high yield corporate bonds or a high yield corporate bond fund (e.g. JNK or HYG). If the investor, however, also has 20% of the portfolio invested in the Franklin Income fund, the exposure to high yield is 27% instead of the 20% the investor allocated to the asset class.

Just as individual investors have increased their tolerance for high yield corporate bonds, so too have funds as they hunt for yield. While funds may have the benefit of size and scale of the portfolio to offset riskier positions, their ability to exit an asset class quickly is limited due to a lack of market depth, especially during periods of stress. As seen a few years ago with the selloff in energy, many funds realized losses on higher quality credit positions, which they liquidated at or near the weakest point in the market, in order to meet individual investors’ demand to exit the fund. The investor who stayed in the fund, therefore, had exposure to weaker credits that the fund was unable to liquidate.

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