INVESTMENT INSIGHTS

The case for a strategic allocation to high yield

From MacKay Shields

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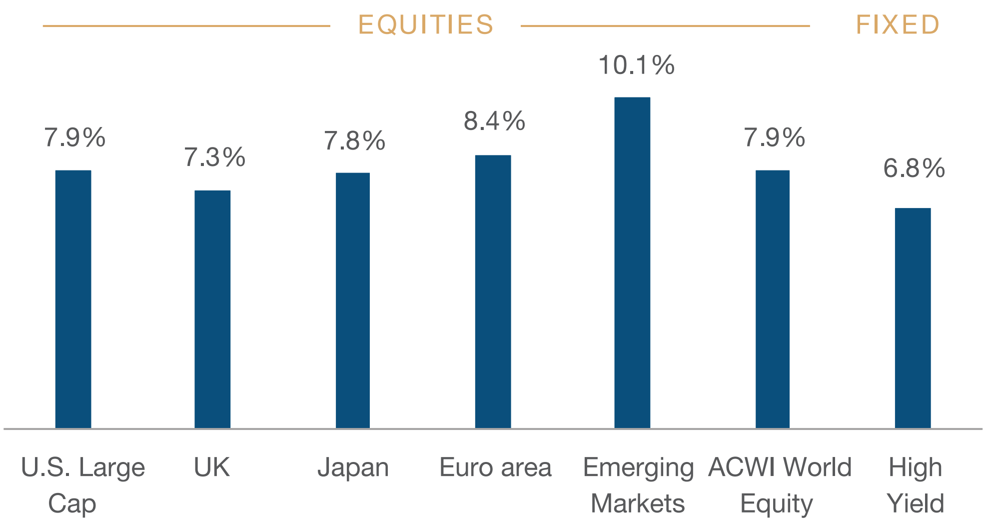
From **MacKay Shields High Yield Team**

We believe the reset in fixed income prices provides a potentially unique opportunity for investors to de-risk their portfolios and benefit from lower expected volatility, but without making a material sacrifice in return potential. Certain forecasts suggest that the returns for high yield in the next few years may be at a similar level to that expected from equities.

It's clear that the changed interest rate dynamic marks a major change in the financial conditions that prevailed during the previous decade. In turn, we believe it's essential to think unconventionally when making high yield allocations.

Figure 1: Selected developed market: Long-term return assumptions

Long-term capital markets assumption forecast period | 10 to 15 year horizon



Total returns in local currency terms, as of September 30, 2022.
Source: JP Morgan Asset Management 2023 Long-Term Capital Market Assumptions.

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High yield attractively positioned

Risk averse investors are often willing to give up potential returns when there are lingering fears of an economic slowdown, which would sap corporate earnings and push up equity price volatility. However, the shift in fixed income markets suggest that the return differential between high yield and equities is minimal, with the former offering potentially less risk. We believe this could be an opportunity for high yield investors seeking compelling returns, while managing their portfolio's risk profile.

Today, high yield bonds trade at spread levels in line with historical averages, providing a yield above 8%.[1] According to some assumptions, high yield bonds may offer a 10-year annualized return that can be highly competitive with the long return expectations for equities, albeit with the possibility of considerably less volatility.[1]

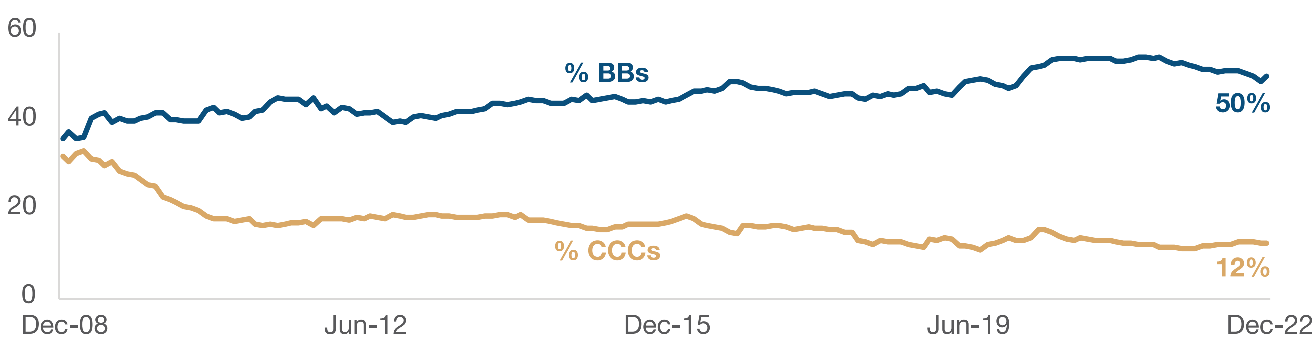
The high yield market today

Changes in recent years have driven structural improvements in the high yield market. The cumulative effect of these shifts has made the market more conducive to investors, particularly more risk averse ones.

It is significant that companies represented in the high yield market in 2023 tend to be of higher financial quality than in previous economic downturns. As of the end of 2022, the ICE BofA U.S. High Yield Index consisted of 50% BB-rated bonds up from 43% in 2011. Meanwhile, the proportion of CCC-rated bonds has decreased to 12% (see **Figure 2** below). This shift can be attributed to generally higher quality issuance, 'fallen angels' and smaller private companies moving to other areas of leveraged credit.

A fallen angel refers to a bond which was originally issued with an investment-grade rating but has since been downgraded to non-investment grade, or high yield status due to the weakening financial condition of the issuing company.

Figure 2: Percent par value in ICE BofA U.S. High Yield Index



Data as of December 31, 2022
Source: ICE BofA U.S. High Yield Index.

One reason for this more encouraging backdrop is the increased presence of public companies, with around 69% of the U.S. high yield market having publicly traded equity. In general, public companies provide more financial transparency which means that investors and analysts can be informed.

Attracting strategic investors

Another change is apparent in the growing numbers of strategic and long-term investors in the high yield sector. This has resulted in greater stability. The investor base has become more diverse and less leveraged to include pension funds and insurance companies as well as institutional buyers from outside of the United States.[2]

All of this has helped to mold the market's increasingly improved issuer profile. Further stability is also coming from the reduced capital flowing into high yield, leading to a market with better quality and less exuberance. (source: Bloomberg)

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[1] Sources: ICE Data, yield to worst of ICE BofA U.S. High Yield Index was 8.6% as of 5/15/2023; JP Morgan Asset Management.

[2] Source: JP Morgan.

Asymmetric returns

High yield offers investors an asymmetric return profile that combines upside potential with downside risk. Nevertheless, compared with equities, high yield's downside risk can be less extreme. Just as stock picking determines the returns of an active equity strategy, skill at individual credit selection is crucial to avoid high yield losses and, in the worst-case scenario, bankruptcies.

In a regime change environment where rates are higher, credit selection will tend to drive return dispersion. This has particularly been the case with the market shift from liquidity driving performance to one where underlying company fundamentals are the primary performance driver. The changed market dynamics, driven by higher rates and reduced liquidity, have correspondingly increased the importance of security selection. We believe this boils down to avoiding losers and picking winners.

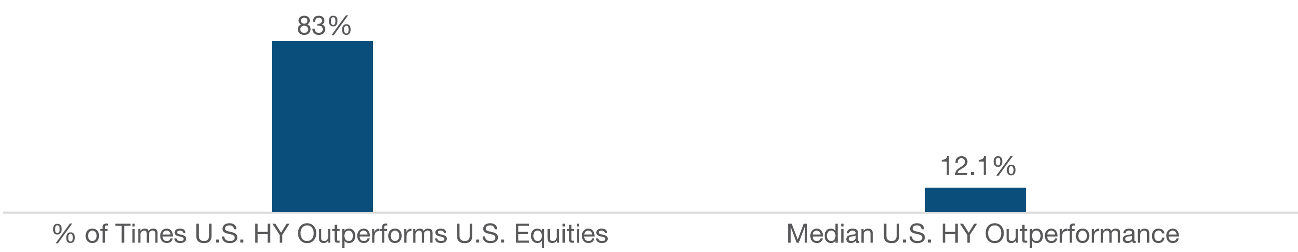
Long-term allocation strategy

A key component of high yield's attraction is the above 8% yields[3] currently on offer, which is around 1.5% higher than their 20-year average. This means that the asset class can generate returns for a portfolio, while providing diversification from equities. In our view, high yield has the potential to match equities returns, while maintaining the potential to outperform in volatile or down markets.

Typically, investors have looked at high yield as a tactical allocation. From a relative value perspective, U.S. high yield has historically outperformed U.S. equities in subsequent one-year periods when the spread between the two is 3.5% or higher (see **Figure 3** below).

Overall, it is our view that the current heightened value the market is offering makes it an ideal time to consider long-term strategic allocations. High yield also provides potentially better risk-adjusted prospects than fixed income sub-strategies such as private credit and leveraged loans which are more heavily exposed to smaller companies in sectors like technology and healthcare.

Figure 3: U.S. high yield subsequent 1-year performance when the spread is 3.5% or higher



Data as of May 15, 2023.
Source: MacKay Shields utilizing Bloomberg data. Spread between ICE BofA U.S. HY Index Yield and the S&P 500 Index Current Earnings Yield. Past performance is not indicative of future results.

Conclusion

We believe there are solid merits to the case for the value in high yield and employing active security selection to unlock it. Such an approach is predicated on understanding individual companies and sectors to build a diverse, all-weather portfolio of high yield credits. Applying this strategy in a consistent, fundamentally focused fashion makes it possible to mitigate downside risk, while taking advantage of attractive entry points in the market.

The current market juncture may offer institutional investors a valuable opportunity to shift higher volatility equity exposure to high yield at a time when returns are expected to be similar but with less risk. Another benefit beyond the attractive yields available is that this is a shorter duration asset class than private credit. What's more, high yield issues are often more liquid than loans and offer more transparency.

The paradigm shift in fixed income markets underscores a fundamentally different financial environment and highlights the need for unconventional thinking in market analysis, security selection and portfolio construction. We encourage investors to consider this opportunity in consultation with their investment partners.

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[3] Sources: ICE Data, yield to worst of ICE BofA U.S. High Yield Index was 8.6% as of 5/15/2023.

About risk

High yield securities (junk bonds) have speculative characteristics and present a greater risk of loss than higher quality debt securities. These securities can also be subject to greater price volatility.

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Definitions

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

The **ICE BofA U.S. High Yield Index** tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The **S&P 500® Index** is widely regarded as the standard index for measuring large-cap U.S. stock market performance.

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