

## INVESTMENT STRATEGY COMMENTARY

### HIGH YIELD BONDS: PLEASE DON'T CALL ME JUNK

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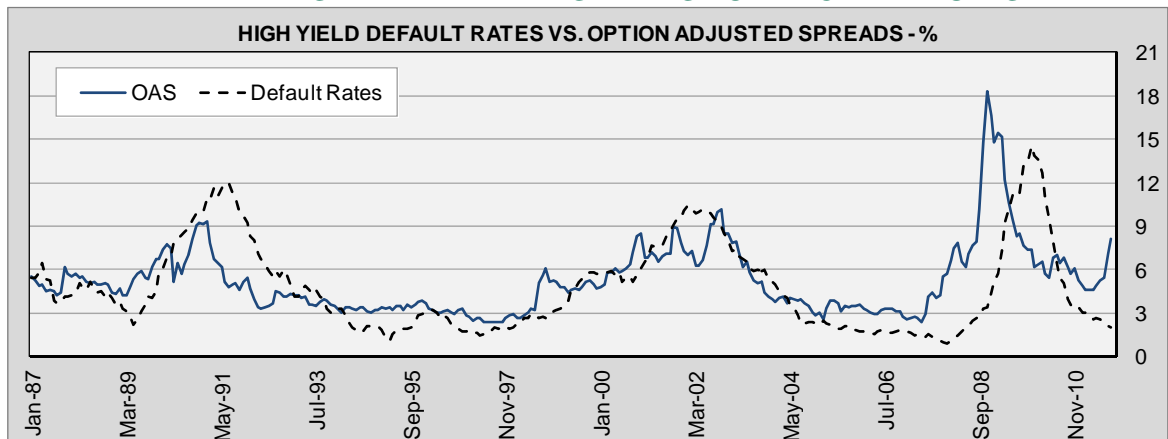
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High yield bonds, the debt issued by non-investment grade companies, are also popularly referred to as “junk” bonds due to the lower credit quality of the issuers. This is understandable when you look at a single issuer, as there is a chance that issuer could default on its debt and the bondholders would thus incur losses. However, when you look at the performance of a diversified portfolio of high yield bonds over time, we think this asset class has very attractive characteristics. Recent worries over the state of the U.S. and global economy, and increased stresses in the financial system, have pressured high yield spreads (the extra interest cost high yield issuers have to pay above U.S. Treasury rates to compensate for credit risk) and depressed investment returns. Because we think the U.S. economy is not going into recession, we find high yield bond valuations attractive today on a 12- to 18-month horizon.

High yield option adjusted spreads (OAS) have widened by about 350 basis points (bps) since their cyclical low in April 2011 and high yield’s yield to worst<sup>1</sup> is now above 10% for the first time since November 2009. While OAS levels have spiked, default rates have continued to trend lower, with the most recent reading right at 2%. In other words, over the past 12 months, a well-diversified portfolio would take a 2% hit in value before considering the ability to recoup some of those losses through claims on assets granted by the debt contract (referred to as recoveries). Exhibit 1 shows these default rates over time – not taking into account recovery values.

#### EXHIBIT 1: SPREAD WIDENING TENDS TO TRACK DEFAULTS



Source: Moody's, Bloomberg, Barclays Capital; monthly data through 9/30/2011.

Clearly, this default rate data series is a backward looking indicator – and default rates in 2007 briefly dipped below 1% before spiking to nearly 15% in the aftermath of the Lehman collapse. As such, it is important to have a forward looking view on default and recovery rates and the fundamentals that drive them. One fundamental input that has started to deteriorate has been the

<sup>1</sup> Yield to worst represents the lowest possible yield obtained on debt securities outside of a default event; it is calculated by assuming the worst case scenario provisions for prepayment, call options, etc.

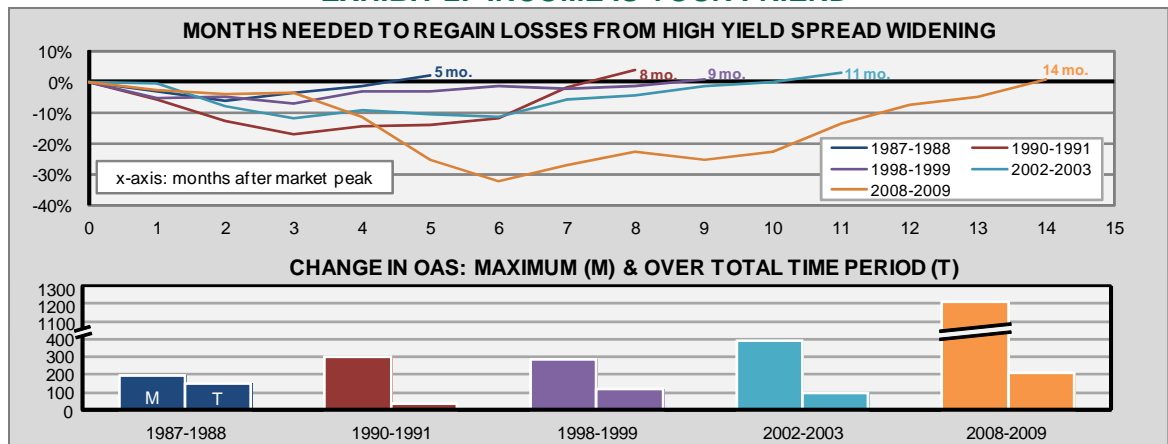


ratio of ratings upgrades to downgrades, which has historically preempted changes in default rates. The ratio of upgrades to downgrades has been improving steadily since the end of 2008 but may have reached an inflection point in August 2011. In August and September, downgrades started outpacing upgrades – a trend worth watching as we assess the impact of growth on corporate credit.

Our long-term (five year) outlook is for high yield to experience a 2.4% average annual default rate – or half of the 4.8% long-term average. This 2.4% rate is based on our expectation for low default rates in the front-end years – supported by healthy balance sheets and low refinancing requirements – giving way to rising (but contained) default rates toward the back end of the five year time horizon as our expectation for a slow growth environment puts potential pressure on company cash flows. If we factor in our long-term expectation for 40% recoveries (in-line with historical averages), we end up with net long-term credit losses of 1.4%. But what if we are wrong about this outlook and the economy deteriorates leading to increasing defaults? How have high yield bond investments performed during periods with increasing spreads and defaults?

Exhibit 2 illustrates five periods of significant spread widening and the subsequent number of months needed to regain losses. Although wider spreads reduce price returns, over time the income received helps offset these price declines – meaning that spreads do not need to return to their previous level in order for investors to generate positive total returns. As an example, in the 2008-2009 experience, investors recouped all of their losses in 14 months even though spreads were still 200 bps wider. Spreads actually bottomed in May 2007, and gradually widened until August 2008 when they started widening dramatically. High yield bond returns during this gradual widening were modestly negative, and if you had bought high yield in May 2007 you would have needed to wait 27 months to return to breakeven. While the economic and financial system downturn in 2008-2009 was historic, so was the scale of the monetary and fiscal programs, which helped high yield bond issuers and investors more quickly than might have been expected.

### EXHIBIT 2: INCOME IS YOUR FRIEND



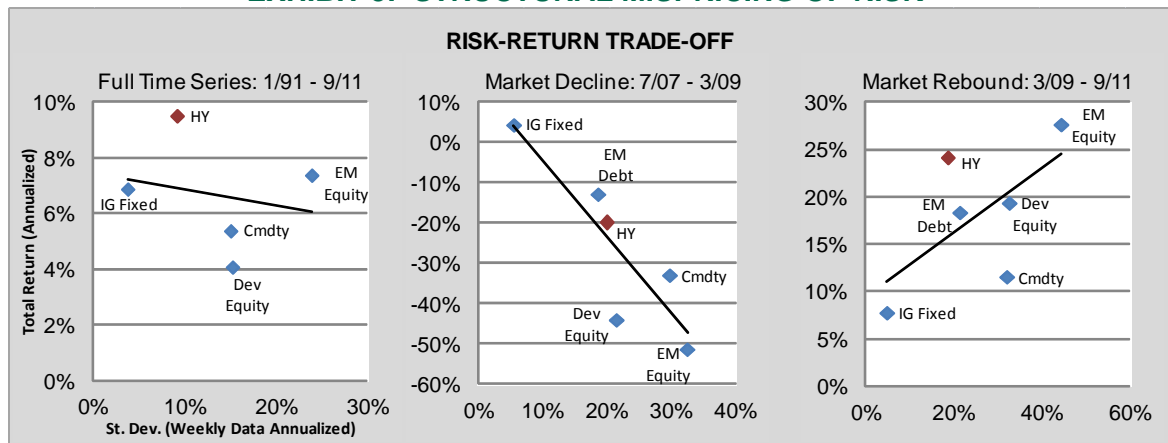
Source: Bloomberg, Barclays Capital, Northern Trust Global Investments.

Note: Starting points selected by looking at material degradations in total returns caused by OAS spread widening.



When looking at the returns on high yield versus its risk profile (as measured by standard deviation on monthly total returns), we believe the value of the underlying income stream is routinely mispriced. That is, investors appear to consistently believe that high yield securities require a higher risk premium (and therefore, lower price) before they are willing to allocate funds. Exhibit 3 shows the risk-return trade-off for various asset classes over three different time periods. Essentially, being above the black line means the asset class is providing a greater-than-required total return when compared to the risk-return profile of other asset classes displayed. High yield, highlighted as a red dot in each scatter plot, has displayed favorable risk-return dynamics over each of the periods listed. During the market decline from 2007 to 2009, high yield fell by 20% (annualized), underperforming investment-grade fixed income and emerging market debt, but outperforming commodities and equities. In the subsequent market rebound, high yield outperformed all asset classes except emerging market equities. Importantly, over the full time period (encompassing three economic cycles), high yield has generated greater returns than any of the other asset classes with lower risk than all but investment-grade fixed income.

### EXHIBIT 3: STRUCTURAL MISPRICING OF RISK



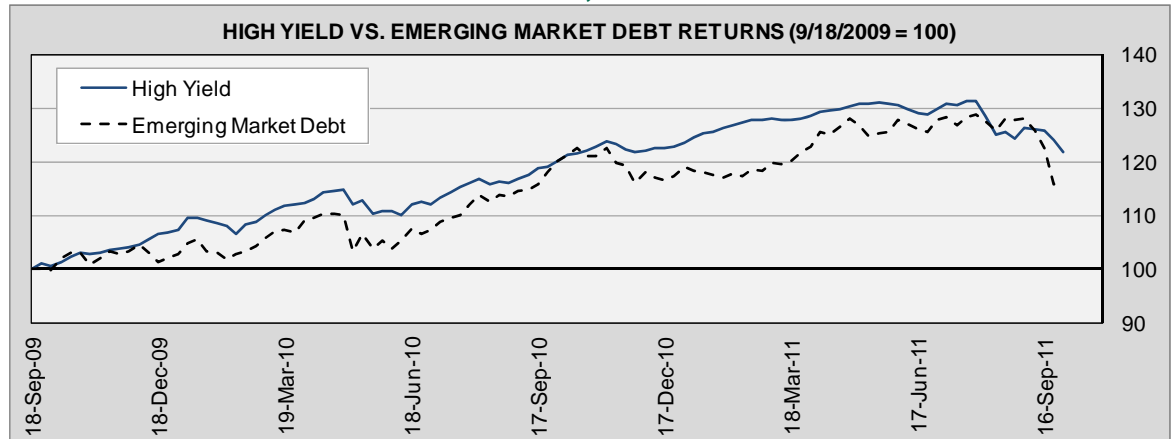
Source: Bloomberg, Northern Trust Global Investments; annualized returns.

Note: Emerging market debt data series only goes back to 2002 and, thus, is not included in "Full Time Series" scatter plot.

Another high-yielding asset class that has been garnering considerable attention over the last few years has been emerging market debt. Since the end of 2002, emerging market bonds (unhedged) have returned 12.1% annually (with an 11.8% risk level), while high yield bonds have returned 9.6% (with a risk level of 11.0%). However, on a hedged basis, emerging market bonds generated a return of only 6.3%. While we agree with some of the longer-term arguments for the asset class, we believe that U.S. high yield can provide similar income – and returns – to emerging market debt without the risk of currency fluctuations. As shown in Exhibit 4, recent performance has supported this view. U.S. high yield debt has outperformed emerging market debt by 5.5% since mid-September 2009 (the date at which we took a more favorable long-term stance on high yield debt). Furthermore, it has done so while undertaking a lower level of risk (6.1% annualized standard deviation versus 10.5% for emerging market debt). We believe U.S. high yield has sufficient return potential to justify its current economic and liquidity risk. Also, the current uncertain economic environment and our liability management approach dissuades us from taking

on currency risk of emerging market bonds in our fixed income portfolio. However, should financial markets improve and “junk” bond yields fall, the idea of diversifying high yield holdings into non-U.S. denominated securities may need to be revisited.

#### EXHIBIT 4: ALL OF THE RETURN; NONE OF THE CURRENCY RISK



Source: Bloomberg; weekly data through 9/30/2011.

In summary, we believe that investors systematically overestimate the risk involved in high yield bond investing. Clear cyclical risks exist in that widening spreads reduce the investment return, mitigated somewhat by the high level of current income. We view high yield bonds favorably today, with a 12- to 18-month horizon, as we believe the U.S. economy is not going into recession and Europe, while keeping it interesting, is able to confine its credit disruption to the Greek, Irish and Portuguese bond markets. High yield bonds are also currently being pressured by selling of funds created for Japanese investors (so called “double-decker funds”) that sought to generate high income by pairing high yield bonds with swaps on certain emerging market currencies; this selling will need to run its course to stabilize current spreads. Should the U.S. economy disappoint, and/or the European debt situation degrade from here, we have demonstrated through our analysis of prior cycles that investors with a longer-term horizon can hold on and may eventually see the benefits of declining spreads and current income.

*Special thanks go to Richard Inzunza, Eric Williams and Jason Mann for their contributions to this report.*

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Investing involves risk, including the possible loss of principal. The potential for higher yield in high yield bonds is a function of the greater risk assumed over similar investments in higher-rated fixed income investments.

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