Wellesley Asset Management
Convertible Bond Specialists 20 William Street, Wellesley, MA 02481 | 781-416-4000

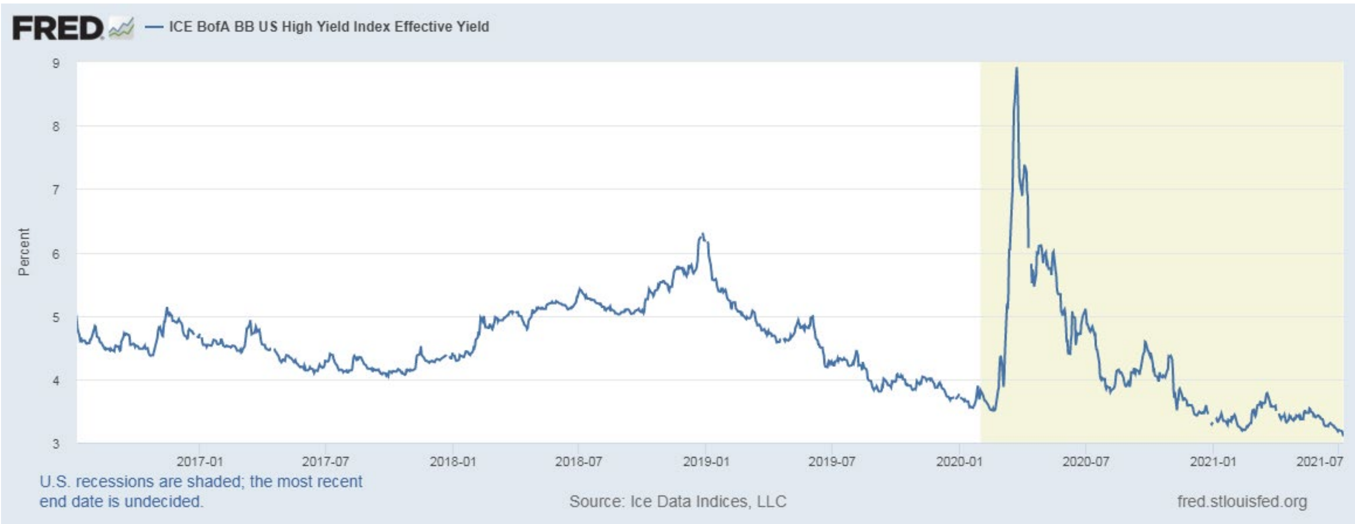
High Yield – High Risk, Low Return

By: Greg Miller CPA, CEO & Portfolio Manager July 13, 2021
Michael Miller, President, CIO
Jim Buckham CFA, Portfolio Manager
Howard Needle, Portfolio Manager – Brenton Partners

A high yield bond investor earns positive returns in three ways -- clipping a coupon or current yield, an increase in value of the bond as holders enjoy the fruits of improved credit worthiness of an investment, or a fall in the general level of market interest rates. With high yield coupons or current yields at historically low levels, the perceived credit worthiness of high yield issuers is extremely optimistic as evidenced by historically tight credit spreads and Treasury rates at very low levels. As such it may be challenging for high yield investors to achieve attractive risk-adjusted returns over the foreseeable investment horizon.

Historically, high yield is yielding very little. The largest ETF representing high yield debt is the iShares iBoxx High Yield Corporate Bond ETF (symbol, "HYG"), which seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds. It had a yield of 4.49% on 7/8/21. Another high yield benchmark, the ICE BofA U.S. High Yield Index, which is market cap weighted and designed to measure the performance of U.S. dollar-denominated high yield debt is depicted below. It has historically provided far higher current income than the effective yield of 3.92% as of 7/8/21:

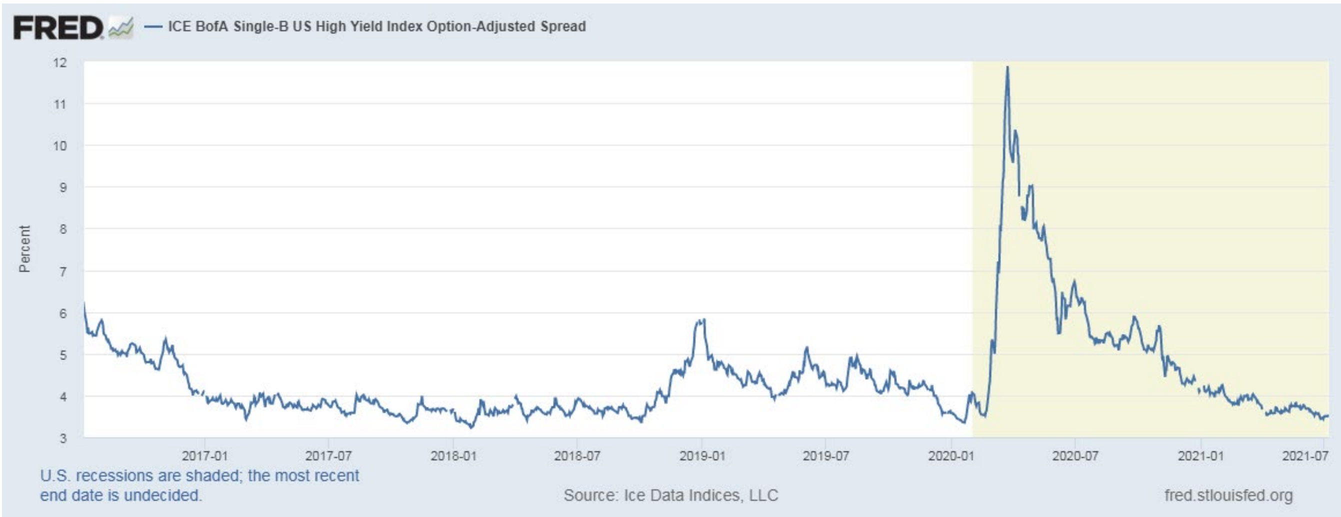
Furthermore, a basket of BB credits, which represents the highest credit quality securities in the high yield market, provides only a 3.10% effective yield:



If investing in high yield for current income, today's current yield of around 3-5% is simply not appealing especially from a historical perspective.

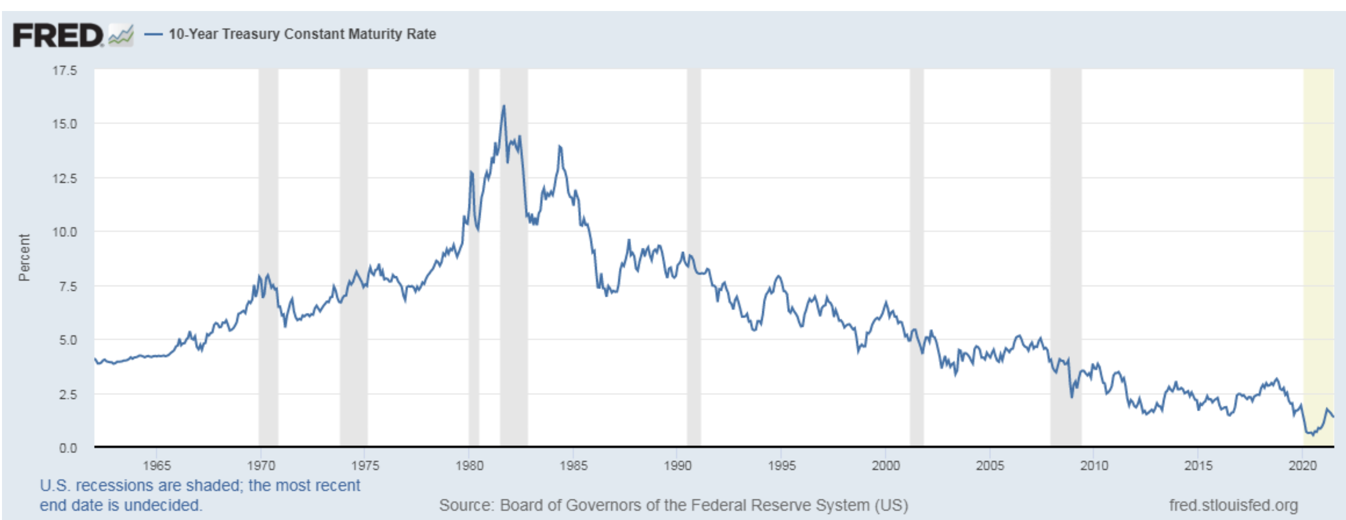
Perceived credit risk is low too. Perceived credit risk is represented by the spread, or increased yield, over similar maturing U.S. Treasury securities. "BB" high yield credits trade with a spread to Treasuries of 218 basis points:

Likewise, “B” credit spreads are also tight to Treasuries trading at a spread of 353 basis points:



Given these tight credit spreads, improved credit worthiness may already be priced into the high yield market. Therefore, it may be challenging to enhance high yield returns (i.e., a bond’s current yield) with improved credit fundamentals as represented by tighter credit spreads or higher bond prices.

As we all know, interest rates are low with the U.S. 10-Year Treasury bond yielding 1.37% as of 7/8/21:



Interest rates can obviously go lower, but given current U.S. growth and inflation projections, estimates are rates will move up from the lower end of their historical range. Any benefit that high yield could receive from lower interest rates via increased bond prices will be immaterial at best. Obviously, if interest rates increased they could have a negative impact on high yield investments.

Given the above, high yield has a lot of good news priced into the market and may be priced for perfection. Further, given paltry current yields of about 3-5% coupled with increasing inflation and inflationary expectations, real returns on high yield investments may go negative. For example, assuming no credit improvement or decreasing U.S. Treasury interest rates (i.e., high yield bond prices remain stable), a high yield investment with a 4% current yield will see a negative real return if inflation is in excess of 4%. A high yield investor may be taking on substantial risk with little to show in terms of return.

The most recent data on inflation is not welcoming for most fixed income and high yield investors. The U.S. inflation rate as of May 2021 was up 5% compared to a year earlier. That means consumer prices increased by more than 5% over the course of a year – the sharpest such increase since August 2008. In other words, a basket of goods and services which cost $100 a year ago now cost $105. The more stable core inflation rate which excludes the impact of volatile oil and food prices increased 3.8%. Moreover, the Federal Reserve in order to provide a backstop to the economy has indicated a willingness to let inflation run "hot" or in excess of their 2% mandate allowing for higher prices and decreased purchasing power. Obviously, any uptick in inflation whether short or longer term will be deleterious for fixed income and high yield investors.

Although the general economic backdrop is positive with accelerating growth and improving financial conditions, high yield investors may have serious headwinds given current pricing. Markets often overreact on the downside and upside. Low interest rates and abundant liquidity may have swung the pendulum too far. The search for yield has pushed fixed income investors out the risk curve and into the high yield market. From a risk / reward perspective, high yield seems to be fraught with risk and may only provide modest if any real returns.