High Yield Bonds

Often Overlooked, Still Compelling

Brandywine GLOBAL

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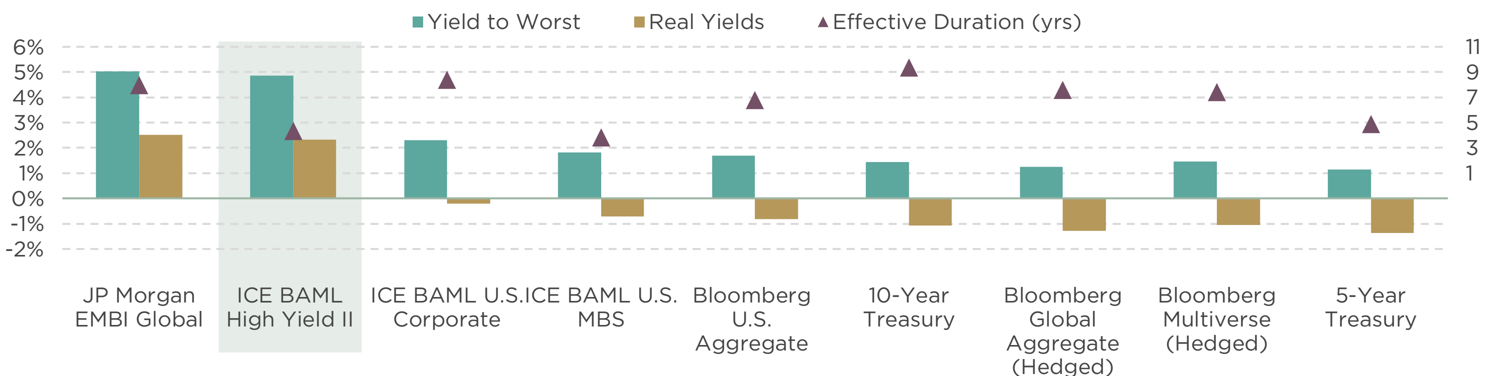
Over the last 40 years, the U.S. high yield bond market has evolved into an established and proven asset class. Yet, for many investors it remains misunderstood, suffering from an image problem and unable to shed its "junk bond" moniker. However, gone are the days when this once esoteric market was comprised primarily of low-grade, highly leveraged fallen angels with no choice but to pay exorbitant interest rates for capital just to survive. Today's high yield market has moved past that stigma, with many companies choosing to be there. It is larger and much improved in quality, and it offers investors advantages both near and longer term. In the current environment, high yield bonds offer a more attractive starting yield and limited interest rate risk relative to other fixed income sectors. Longer term, the sector's ability to produce strong risk-adjusted returns across various business and financial cycles can make it an attractive complement to traditional asset classes.

The Current Case for High Yield

1. Attractive Yields with Limited Duration

In the current environment of low yields and high inflation, investors face a fixed income market in which there are few options globally that offer starting yields above expected inflation. Most fixed income sectors also have significant interest rate risk with a duration well above the starting yield. In contrast, high yield offers a starting yield above expected inflation and a duration below the starting yield (see **FIGURE 1**). The negative real yields that plague most fixed income sectors are no accident. Policymakers around the globe want to keep government bond yields below inflation so that debt-to-gross domestic product (GDP) ratios can stabilize and even decline over time. This situation is known as financial repression, and it likely will be with us for a long time.

1 | **Real Yields by Sector**
% (left), Years (right), As of 12/31/2021



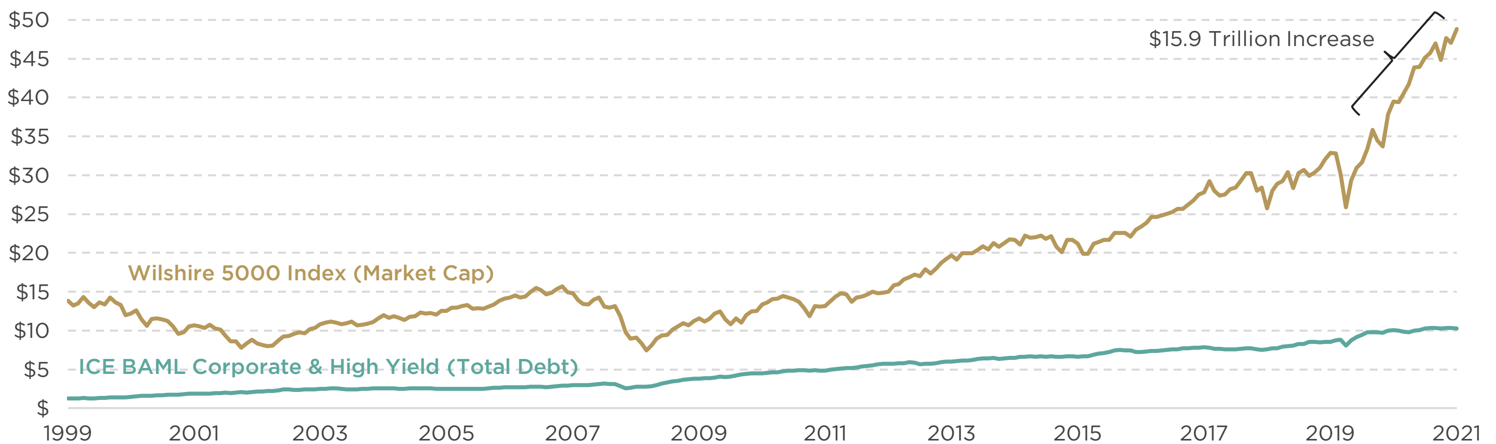
Source: Bloomberg (© 2022, Bloomberg Finance LP), ICE BAML, JP Morgan

2. An Historic Equity Cushion

For all the talk about the record issuance and level of corporate debt, it pales in comparison to the immense growth in U.S. equity markets. For example, the Wilshire 5000 Index has seen its market cap grow by nearly $16 trillion since the beginning of 2020, compared with the corporate debt market, which is close to $10 trillion in its entirety (see **FIGURE 2**). Of this amount, high yield bonds are about $1.6 trillion with the remainder investment grade. U.S. corporate debt relative to the size of the economy is currently above the high end of its historic range. However, the market value of U.S. equities is much further above the high end of its historic range. As a result, the face value of U.S. corporate debt relative to the market value of domestic equities is at generational lows (see **FIGURE 3**). While the overlap between these markets is not perfect, the point is clear: The value of the equity cushion supporting high yield bonds is extremely high. This equity cushion leads to a positive feedback loop, decreasing the probability of default and improving access to capital.

2 U.S. Equity Market Capitalization vs. Total Corporate Debt Outstanding

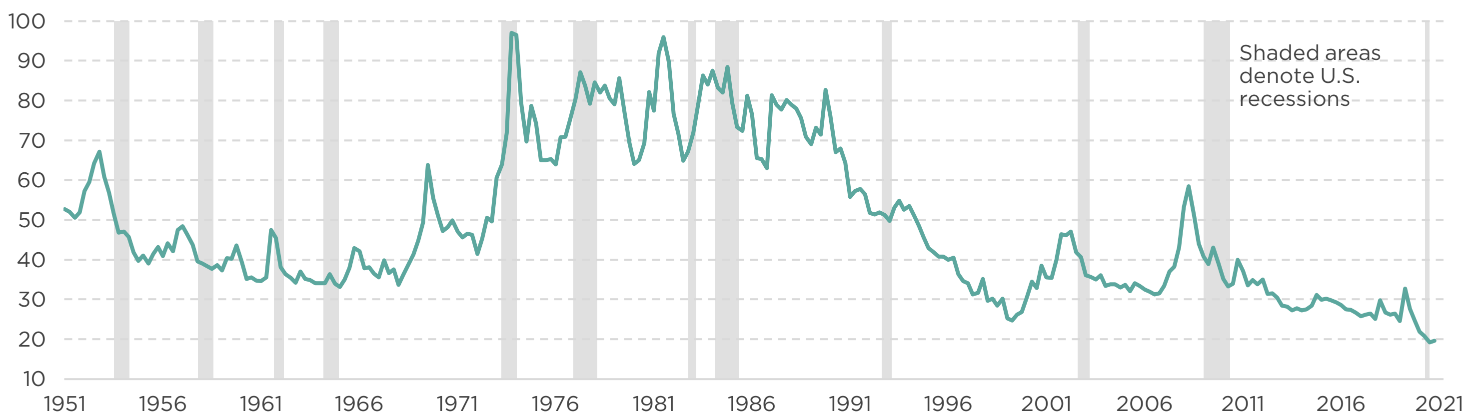
$ Trillion , As of 12/31/2021



Source: Bloomberg (© 2022, Bloomberg Finance LP)

3 Nonfinancial Corporate Business: Debt as a Percent of Market Value of Corporate Equities

%, Not Seasonally Adjusted, As of 7/1/2021



Source: Board of Governors of the Federal Reserve System (U.S.)

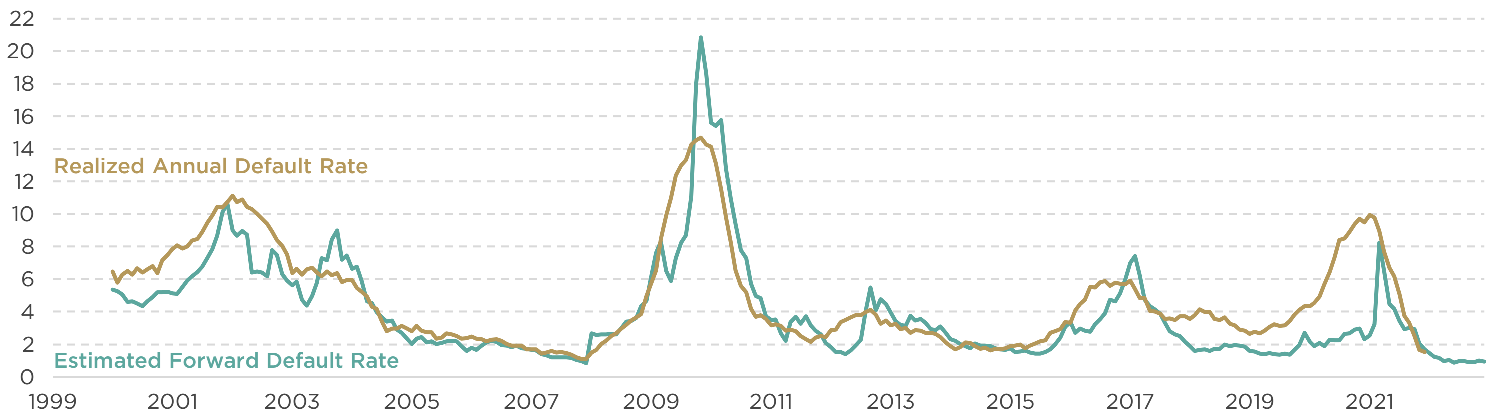
It is understandable why investors may be wary of “tight spreads” and “historically low yields” within high yield. However, we feel this view ignores the technical and fundamental argument of how we got to this point. From a technical perspective, COVID-19 pandemic relief included Federal Reserve (Fed) facilities financed by Congress to purchase certain investment grade and high yield bonds and ETFs. We believe this was a regime change that ultimately will lead to structurally tighter credit spreads going forward. Tighter credit spreads also have contributed to a lower cost of capital for U.S. businesses and, ironically, may have had an even greater impact on the move higher in equity valuations.

3. Fundamentally Improved Market

From a fundamental point of view, today's high yield market is nothing like the troubled junk bond market of the 1980s. The factors discussed above along with strong corporate earnings have brought high yield defaults down to very low levels. We expect defaults to stay well below historic averages for the foreseeable future as seen in estimated forward default rates (see **FIGURE 4**). In prior cycles, defaults have remained low for several years before ticking higher again. We believe this time will be no different, particularly given unprecedented liquidity across all sectors of the economy and a business cycle that still has plenty of room to run.

4 U.S. High Yield Default Rates

%, As of 12/31/2021

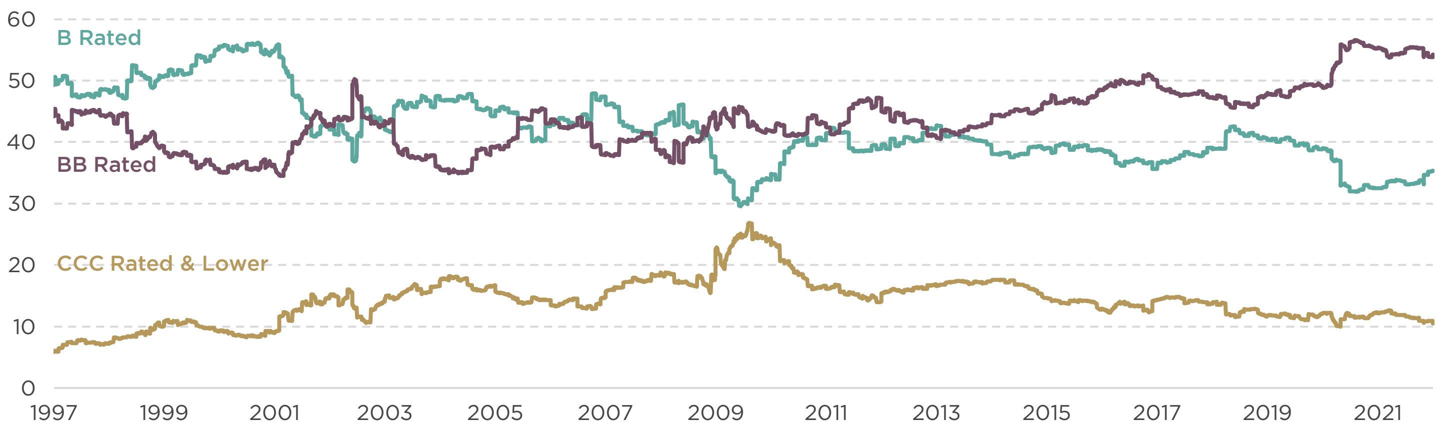


Source: Brandywine Global, Macrobond, ICE BAML

Furthermore, the ratings composition over time illustrates the improved credit quality of the high yield market compared to prior cycles. BB-rated debt, which rarely defaults, is now over 50% of the market (see **FIGURE 5**). Many high-return and fast-growing businesses have decided to access the high yield market even though they do not need the capital.

5 U.S. High Yield Quality Allocation: Market Value Weights by Credit Quality

%, ICE BAML U.S. High Yield Index, As of 12/31/2021



Source: Brandywine Global, Macrobond, ICE BAML

The Structural Case for High Yield

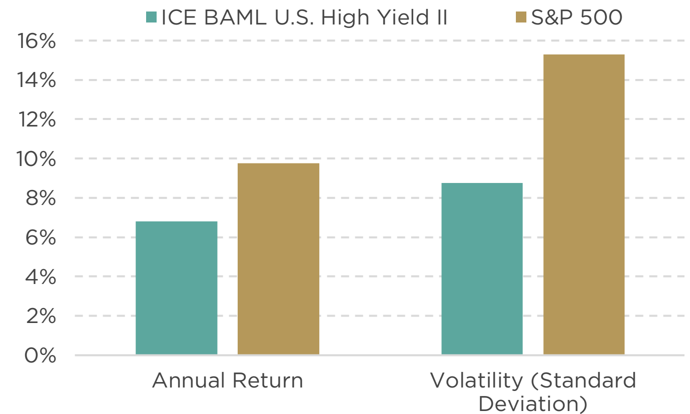
While high yield is attractive compared to other fixed income sectors today, the structural case for a strategic allocation to high yield is also compelling.

1. Attractive Risk/Return

High yield has historically achieved much of the upside of equities with considerably less volatility. For example, over the last 25 years, the ICE BAML U.S. High Yield Index returned nearly 6.8% annualized, which is about 70% of the total annualized return of the S&P 500 over the same period, but with significantly less volatility (see **FIGURES 6 AND 7**). The same attractive volatility story remains consistent looking at the 3-year annualized standard deviation over the last 20 years. The high yield asset class historically has been much less volatile than the broad equity market (see **FIGURE 8**).

6 | 25-Year Risk/Return Comparison

%, 12/31/1996 - 12/31/2021



Source: Bloomberg, ICE BAML

7 | 25-Year Risk/Return Metrics

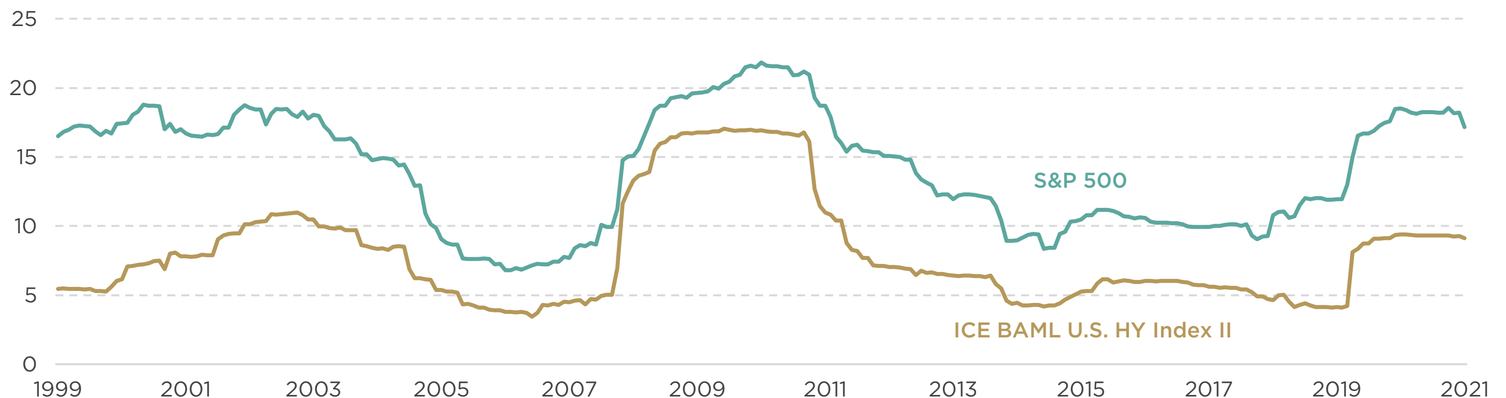
12/31/1996 - 12/31/2021

Name	Annual Return	Volatility (Std Dev)	Sharpe Ratio	Max. Drawdown	Time to Recover (months)
ICE BAML U.S. High Yield II	6.79%	8.76%	0.55	(33.23%)	9
S&P 500	9.75%	15.30%	0.51	(50.95%)	37

Source: Bloomberg, ICE BAML

8 | Rolling 3-Year Standard Deviation

%, As of 12/31/2021



Source: Bloomberg, ICE BAML

A comparison of the risk/return relationship amid various equity market environments furthers the case for high yield. Since the turn of the millennium, high yield has delivered consistently strong long-term returns across a wide variety of market cycles. Breaking this period into two equal halves helps illustrate this consistency (see **FIGURE 9** on next page). The first half, from December 31, 1999, through December 31, 2010, began with equities experiencing the collapse of the dotcom bubble in

early 2000 and ended with stocks recovering from another historical recession. For this 11-year span, the S&P 500 Index was essentially flat with a 0.41% return for the period. Meanwhile, high yield outperformed equities with a 7.27% return over the same time frame—and with lower volatility.

In the subsequent 11 years, the S&P 500 posted an unusually strong annualized 15.15%. Over the same period, the high yield market still delivered an attractive 6.50%—and again with smaller drawdowns and lower volatility over the broad equity market. With its tendency to sit in a favorable "Goldilocks" segment of an asset allocation, high yield has exhibited characteristics of both traditional fixed income and equities. Historically, it has generally provided more muted drawdowns during periods of market volatility and attractive returns during flat markets while capturing a significant portion of the upside in favorable equity environments.

9 Growth of $100: S&P 500 and ICE BAML U.S. High Yield

$, 12/31/1999 – 12/31/2010

Period 1 – Date Range: 12/31/1999 – 12/31/2010

Name	Annual Return	Max. Drawdown (Monthly)	Volatility (Std Dev)	Sharpe Ratio
ICE BAML U.S. High Yield II	7.27%	(33.23%)	10.95%	0.43
S&P 500	0.41%	(50.95%)	16.35%	(0.13)

Period 2 – Date Range: 12/31/2010 – 12/31/2021

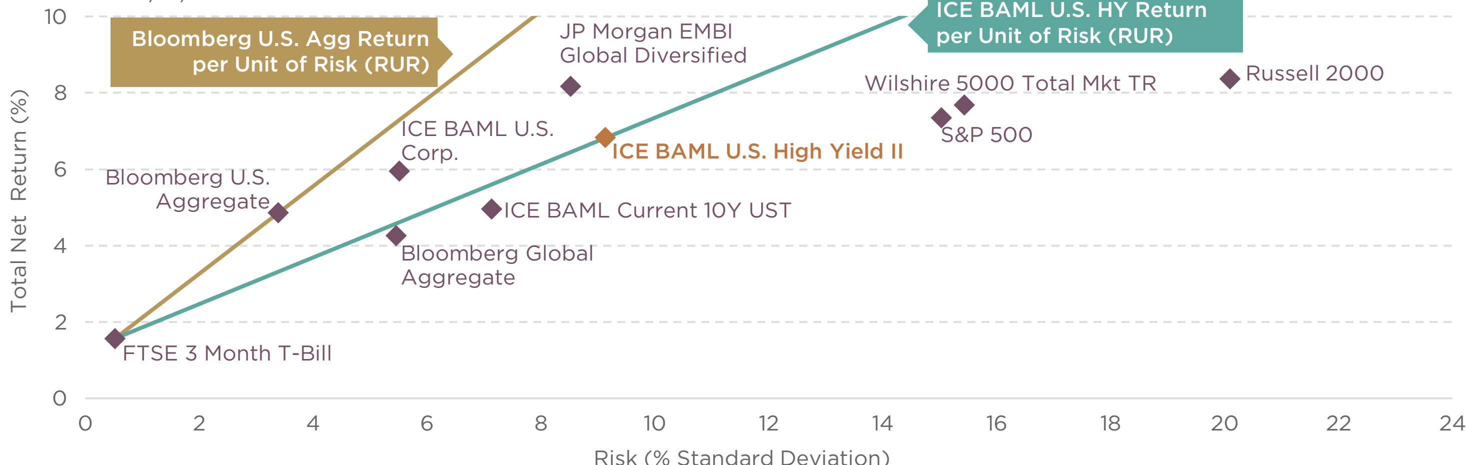
Name	Annual Return	Max. Drawdown (Monthly)	Volatility (Std Dev)	Sharpe Ratio
ICE BAML U.S. High Yield II	6.50%	(13.13%)	6.81%	0.87
S&P 500	15.15%	(19.60%)	13.29%	1.10

Source: Bloomberg, ICE BAML, Brandywine Global

High yield also stands out historically compared to other asset classes on the return-volatility relationship (see **FIGURE 10**). This combination of attractive, returns and lower volatility supports the case for a structural allocation to high yield.

10 U.S. High Yield: Attractive Returns with Lower Volatility

As of 12/31/2021



Source: Bloomberg, ICE BAML, JP Morgan, FTSE Russell, Wilshire

2. Case for High Yield as the Cycle Matures

Recessions are always a concern, and while we can never be certain when they will occur, investors want to ensure their overall portfolios can weather the storm when it arrives. Equally important is the comfort of knowing that when it passes, they have a portfolio that will realize the benefits of any market dislocations and capture a sizable amount of the upside. High yield is an asset class with historical performance that may align with these objectives. With the exception of the 2020 recession, compared with equities, high yield has historically experienced smaller drawdowns and faster recoveries, leading to outperformance going into and coming out of recessions (see **FIGURE 11**). This tendency makes sense since a high yield bond is a senior security with contractual interest payments and a maturity date. Because recessions are difficult to forecast, we believe an allocation to high yield may allow an investor to participate in the later stages of the business cycle, which can last for years, while being better positioned for a recession than equities. The 2020 recession was unique in that it was driven by a global pandemic-related shutdown, rather than a traditional economic cycle, which ultimately led to massive and sustained fiscal and monetary responses that were particularly beneficial to equities.

11 High Yield Performance During and Following Recessions

Recession Period

July 1990 to March 1991	Recession Return (Ann)	18 Months After (Ann)	Recession + 18M (Ann)
ICE BAML U.S. High Yield II	8.72	24.16	19.90
S&P 500	7.64	10.86	10.68
March 2001 to November 2001			
ICE BAML U.S. High Yield II	(2.45)	7.60	3.85
S&P 500	(7.18)	(9.06)	(9.20)
December 2007 to June 2009			
ICE BAML U.S. High Yield II	(2.86)	25.29	9.94
S&P 500	(24.16)	25.77	(3.00)
February 2020 to April 2020			
ICE BAML U.S. High Yield II	(9.82)	14.81	6.11
S&P 500	(9.26)	37.88	24.59

Source: ICE BAML, S&P Global

3. Performance in Rising Rate Environments

While interest rates are well off the incomprehensibly low levels reached during the first part of the pandemic, there is still a reasonable probability that they will move materially higher in the future. High yield is an asset class that has historically held up well during rising rate periods. First, high yield bonds tend to issue in shorter maturities, typically resulting in a lower duration profile versus other fixed income sectors. This shorter duration makes high yield less sensitive to rising interest rates. Investment grade credit, for example, has much more duration risk. Second, rates often rise in concert with economic growth during expansionary periods, which tends to be a tailwind for high yield (see **FIGURE 12** on next page).

12 Comparative Index Performance during Periods of Rising Interest Rates

Start Date	End Date	Change in 10-Year UST Yield (Delta)	Bloomberg U.S. Aggregate	ICE BAML U.S. Corp	J.P. Morgan EMBI Global Diversified	ICE BAML U.S. High Yield II	Russell 2000	S&P 500
10/31/2001	3/31/2002	1.16	-0.54	-1.2	6.04	0.93	10.4	1.15
5/30/2003	6/30/2006	1.77	1.93	2.03	9	9.21	18.84	11.36
12/31/2008	12/31/2009	1.63	5.93	19.76	29.82	57.51	27.16	26.46
8/31/2012	12/31/2013	1.48	-1.26	0.36	-0.76	9.18	32.85	25.45
6/30/2016	10/31/2018	1.67	-0.64	0.52	1.88	6.75	13.81	13.84
7/31/2020	3/31/2021	1.21	-3.56	-3.03	-0.37	7.37	51.17	22.78

Source: Bloomberg, ICE BAML, JP Morgan, FTSE Russell

Conclusion

The U.S. high yield market has evolved significantly over the past several decades and is now far removed from its “junk bond” past. It is a market that has seen exceptional improvement in both credit quality and fundamentals with an enhanced margin of safety. Still, the market has not fully shed its outdated reputation and remains underappreciated by many investors. However, this overlooked corner of the bond market may deserve a place in investors’ portfolios, both near and longer term. Currently, the high yield market continues to offer attractive yields above inflation with limited interest rate risk. Historical characteristics are also compelling, including high yield’s track record of protecting capital during periods of equity stress. It is an asset class that has proven to be all weather, and if positioned accordingly, may potentially boost a portfolio’s returns and increase diversification, all while adequately compensating investors for the risk.

These characteristics make high yield attractive and also put it in an advantageous middle ground between equities and core fixed income. High yield may capture much of the return of equities over time with considerably less volatility, including smaller drawdowns during periods of economic stress. Additionally, high yield has frequently provided this compelling risk/return profile along with an attractive income stream. This affinity to both equities and fixed income presents investors with allocation options. When investing in high yield within an overall portfolio, investors may draw from either their equity or core fixed income allocations—or both. This versatility only serves to enhance the appeal and relevance of high yield as an essential component of a diversified portfolio for many investors.

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