Balancing Yield and Risk, Global BB/B High Yield Offers Compelling Opportunities

Historically, higher-quality high yield investments, rated BB/B, have been most popular with conservative credit investors or those with regulatory requirements prohibiting lower-quality credit, below CCC. However, with credit markets in the prolonged late stages of the credit cycle and interest rates at record low ranges, the investment landscape has changed dramatically. Yield-starved investors have been forced into lower-quality assets and potentially more volatile sectors to obtain income and attractive total return. Unfortunately, this reach for yield often introduces investors to unwanted, heightened risk, including higher default risk and interest rate risk. Some investors have moved to less familiar asset classes, such as direct or distressed lending, which come with significant liquidity constraints and a lack of transparency with respect to pricing and historical performance.

Relative to this new backdrop, we believe investing in BB/B-rated credit represents an attractive solution for investors—not just those with credit-quality constraints—as both a complement to lower-yielding investments or as a replacement for low-quality, high-risk alternatives. A permanent allocation to higher-quality global high yield has the potential to provide attractive equity-like returns with lower volatility and default risk, both relative to global high yield broadly and other asset classes. Furthermore, we believe the expansion of the asset class has led to increased opportunities. The outdated perception of high yield as fraught with defaults and other risks has been replaced by improving fundamentals driven by a wave of refinancing since the Global Financial Crisis, while more sound operating performance has diminished credit risks. The BB/B-rated segment offers substantial liquidity relative to other higher-yielding alternatives, and an allocation to higher-quality high yield may provide investor portfolios with several diversification benefits.

HIGHER-QUALITY HIGH YIELD OFFERS ATTRACTIVE, EXPANDED OPPORTUNITY SET

Several factors, including attractive risk/return characteristics, have led to increased opportunities within the higher-quality high yield segment.

1. **The case for BB/B relative to global high yield and lower-quality credit.** High yield is not a homogenous asset class, and there are nuances that will dramatically alter risk/return profiles across different segments. It is important to understand how these differences can impact risk and return over the long term. According to Standard & Poor's, 65% of issues rated CCC to C historically have defaulted within five years, compared with 3.4% for BB-rated bonds. Focusing

Figure 1 Comparison of BofA Merrill Lynch Global High Yield Index, BB-B Global High Yield, and CCC Annualized Returns and Risk Statistics 1/1/1999 to 12/31/2016

	GHY	BB-B GHY	CCC GHY
Annualized Returns (%)	6.90	6.65	7.36
Annualized Standard Deviation (%)	9.98	8.96	15.00
Risk-Adjusted Return	0.69	0.74	0.49
Upside Capture (%)		91	139
Downside Capture (%)		90	143

Source: Brandywine Global, Bloomberg L.P., Bank of America Merrill Lynch, Standard & Poor's

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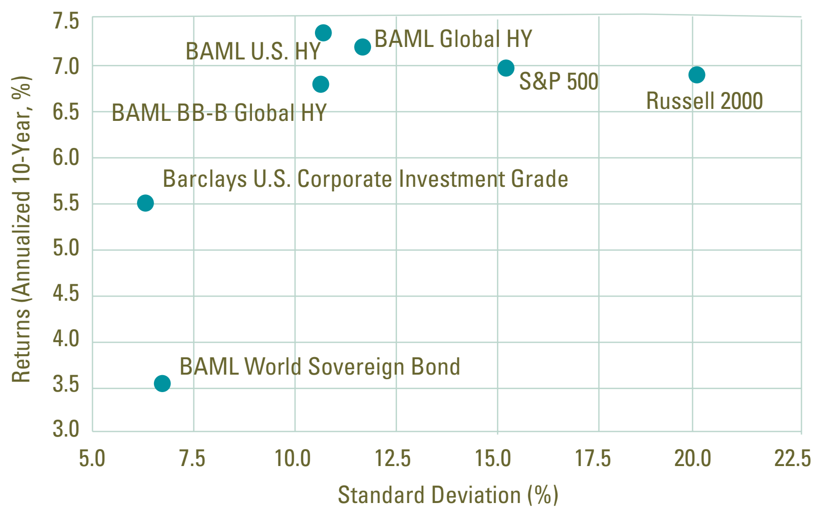
investments in higher-quality high yield historically has resulted in stronger risk-adjusted returns and better downside protection compared to investing to CCCs (see **Figure 1** on previous page).

2. **Equity-like returns.** Relative to other fixed income asset classes, higher-rated global high yield can provide equity-like returns with relatively low volatility (see **Figure 2**). With a hybrid risk-return profile that combines characteristics of both fixed income and equities, higher-quality global high yield bonds offer an attractive trade-off to investors.
3. **Lower default rates.** The attractive risk/return profile provided by BB/B is further enhanced by relatively low default rates. Compared to investment grade credit, moving down the quality spectrum to BB/B can offer significant return potential without a commensurate increase in default risk. However, the same statement does not hold true with the move down to CCC-rated high yield. These lower-quality issues are characterized by a disproportionate increase in defaults relative to higher-rated bonds (see **Figure 3**).

Figure 2 Total Return of Indices versus Standard Deviation of Indices As of 1/1/2017



Results displayed in U.S. dollar (USD). Data frequency used: Monthly.
Source: Bank of America Merrill Lynch, Bloomberg L.P., Standard & Poor's, FTSE International Limited and Frank Russell Company

Figure 3 Descriptive Statistics on One-Year Global Default Rates (%) As of 12/31/2015

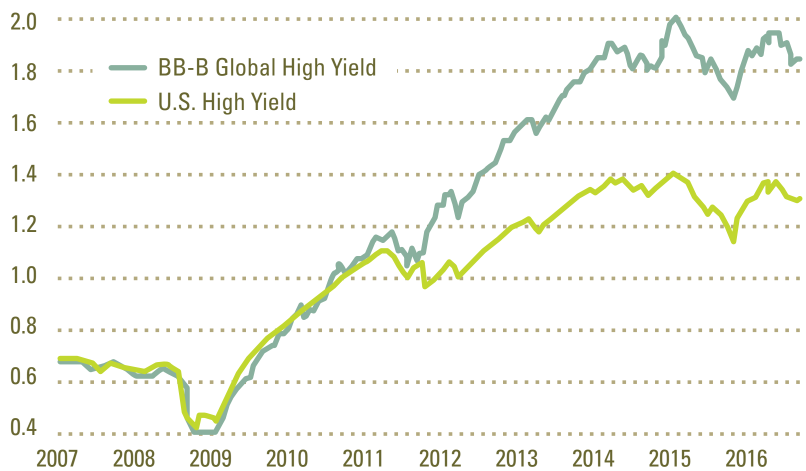
	AAA	AA	A	BBB	BB	B	CCC/C
Minimum	0.00	0.00	0.00	0.00	0.00	0.25	0.00
Maximum	0.00	0.38	0.39	1.01	4.22	13.84	49.46
Weighted Long-Term Average	0.00	0.02	0.06	0.19	0.73	3.77	26.36
Median	0.00	0.00	0.00	0.07	0.70	3.41	23.08
Standard Deviation	0.00	0.07	0.11	0.26	1.02	3.33	11.83
2008 Default Rates	0.00	0.38	0.39	0.49	0.81	4.08	27.27
Q1 2015 – Q4 2015	0.00	0.00	0.00	0.00	0.16	2.39	25.73
Difference Between Q1 2015 to Q4 2015 and Weighted Average	0.00	-0.02	-0.06	-0.19	-0.57	-1.38	-0.63
Number of Standard Deviations	0.00	-0.30	-0.60	-0.73	-0.56	- 0.41	-0.05

Source: Standard & Poor's Global Fixed Income Research and Standard & Poor's Credit Pro®

4. **Expanded opportunity set, as global high yield outpaces U.S. market.** Due to an increase in downgrades from investment grade credit and a growing number of small- and medium-sized enterprises (SMEs) accessing the debt capital markets after the Global Financial Crisis across Europe and developing markets, the total market value of the global high yield segment rated BB/B has outgrown the entire U.S. high yield universe over the past four years (see **Figure 4** on next page), leading to expanded options for experienced active credit investors.

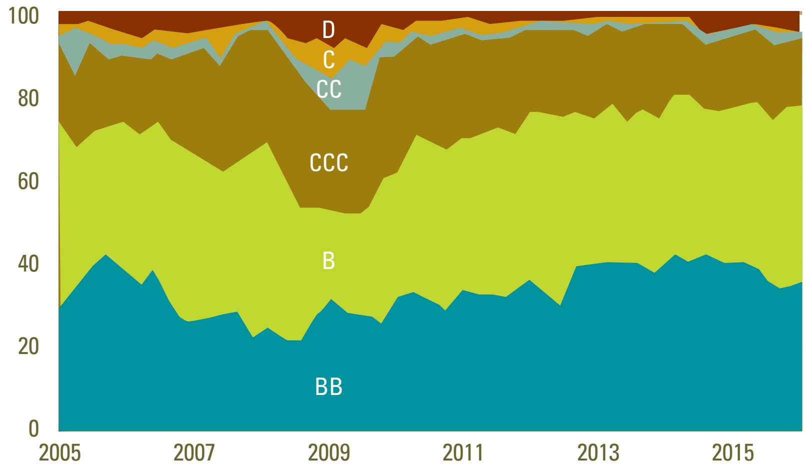
5. **Reduced liquidity risk.** Furthermore, the expansion of the higher-quality segment allows investors to avoid going down in quality to less liquid securities. With traditional high yield managers dipping farther down the credit quality spectrum to chase yield, investors may be overexposed to CCC and highly illiquid segments of the credit markets. As shown in **Figure 5**, BB/B issues comprise the bulk of the trading volume since the Global Financial Crisis and provide sufficient liquidity and opportunity (see **Figure 5**).
6. **Access to fallen angels.** Another benefit to investing in BB/B-rated credit is the access it provides to fallen angels, a segment that has significantly outperformed original-issue high yield globally. Fallen angels also represent a growing portion of the global high yield universe, increasing from about 8% of the market in 1999 to 22% today. High yield fallen angels are bonds that were investment grade at the time of issuance but have since been downgraded to below investment grade. What may surprise some investors are the many household names that are now or have been a fallen angel. For example, Apple was a fallen angel in the late 1990s. More recently, the biggest fallen angels include the likes of Anglo-American and Dell. However, their tarnished reputation may be undeserved. A comparison of BB/B-rated global high yield, which includes fallen angels, compared to global CCC-rated credit shows that higher-rated high yield has outperformed lower-rated credit **65%** of the time on a 12-month risk-adjusted basis.[1] In recent years, the outperformance of higher-quality high yield, particularly fallen angels, compared to the broad high yield universe is especially notable (see **Figure 6**).

Figure 4 Global BB/B High Yield Has Outpaced U.S. Market In Millions, As of 2/1/2017



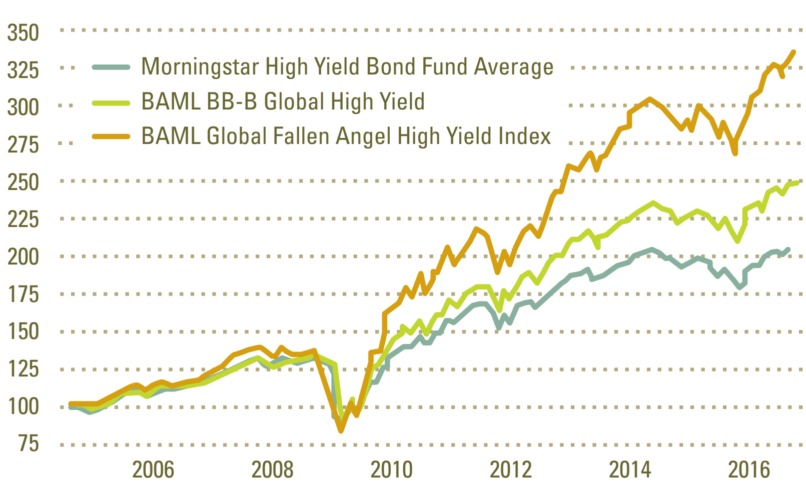
Source: Bank of America Merrill Lynch, Bloomberg L.P.

Figure 5 BB/B Credit Represents the Majority of High Yield Trading Volume %, As of 9/30/2016



Source: SIFMA

Figure 6 Historic High Yield Index Returns As of 12/31/2016



Source: Bank of America Merrill Lynch, Bloomberg L.P., Morningstar, Inc.

1. Sources: Brandywine Global, Bloomberg L.P., Bank of America Merrill Lynch. Calculated using monthly data on a rolling, trailing twelve-month risk-adjusted basis from the trailing one-year period beginning December 31, 1999, through December 31, 2016.

7. **Improved quality and potential for spread compression.** The average quality of the global high yield BB/B market has continued to improve during the past decade from B1 in 2006 to BB3 today. One segment, fallen angels, generally has a higher credit quality than original-issue high yield. Ratings agencies tend to apply a backward-looking bias rather than a forward-looking outlook with respect to downgrades, a potential weakness that may cause fallen angels to be undervalued. These issuers tend to have the ability to access the capital markets as a way to shore up their liquidity situations. For example, fallen angels, which are generally publicly traded companies, often have well established relationships with shareholders, banks, and bond-holders compared to more leveraged private companies. Furthermore, during volatile periods, debt issuance for lower-quality bonds, such as CCCs, has tended to decline as a percentage of high yield new issuance. In 2015, with concerns centered on commodity-related sectors and defaults, CCC issuance dipped to 8% of total issuance compared to over 15% in 2013. Additionally, management teams within fallen angels are usually incentivized to regain investment grade status. These factors are not necessarily reflected in their ratings. Lastly, fallen angels typically have longer duration, generally are not callable, and offer a different sector composition than original-issue high yield. We attribute the superior performance of fallen angels to forced selling and overreaction by investment grade investors, as well as more attractive call features, which can offer better total returns when spreads rally.

   There are several events within the BB segment that can provide a catalyst for transforming issues into rising stars and returning them to investment grade. For example, BB credits can be attractive targets for mergers and acquisitions (M&A) by larger investment grade competitors. This trend has been a theme in the food & beverage and communications sectors. Due to their long investor history, fallen angels generally have better access to the capital markets, both equity and debt, which can help their liquidity and debt-financing profile. Being better capitalized than smaller, more leveraged issuers, these companies have more flexibility for internal investment to improve efficiency and productivity, which helps competiveness and cash flow. Strong management incentives are a further impetus driving upgrades. Once an issue gets upgraded to investment grade, material credit spread compression tends to occur, resulting in capital appreciation and attractive total return.

ALLOCATION TO HIGHER-QUALITY HIGH YIELD PROVIDES SEVERAL BENEFITS

As the global high yield market expands, providing increased opportunities and improved characteristics to investors, we believe a permanent allocation to higher-quality high yield is warranted as either a complement to core allocations or as a replacement for illiquid or high-risk high yield alternatives, such as private credit. Considering the alternatives given the current environment, an allocation to investment grade credit may be enhanced by adding exposure to higher-quality high yield, moderating interest rate risk while avoiding excessive default risk. In comparison, a complement of traditional high yield does not necessarily isolate the same benefits and may expose investors to other risks. Amid the low yield environment, many traditional high yield managers have gone down in quality, leaving investors potentially overexposed to CCC. When these allocations are further paired with long/short strategies, direct or distressed lending, or other illiquid strategies, investors bear potentially excessive and unintended default and liquidity risks. We believe an allocation to BB/B-rated credit provides several advantages over traditional high yield mandates and non-traditional high yield alternatives.

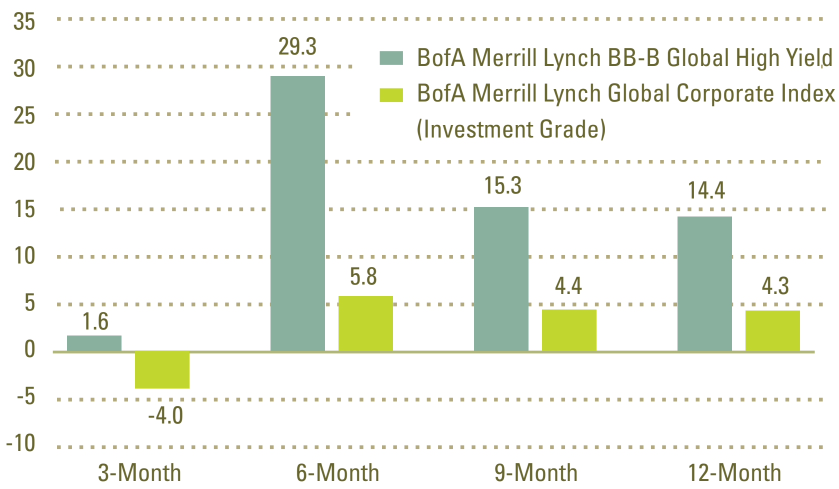
1. **Global BB/B can enhance investment grade credit exposure, creating a multi-purpose, defensive high yield strategy that avoids default risks of lower-rated high yield.** Normally, in a standard barbell approach, the duration from investment grade credit is used to protect portfolios that have moved into lower-quality, lower liquidity segments. However, given the risks associated with reaching down the spectrum of quality and liquidity, we advocate a defensive approach, which tilts toward higher quality. When duration warrants, investment grade credit is utilized for deflationary protection. Conversely, our approach will go down in quality when needed by focusing on select BB/B-rated credit to generate returns comparable to traditional high yield while avoiding CCCs and alternative credit, as well as their characteristic default and liquidity risks.

   Global BB/B high yield can enhance investment grade credit in several environments, creating a defensive, multi-purpose high yield strategy. Higher-quality high yield typically has less duration sensitivity than BBB or investment grade credit, which means that in an environment of increasing rate volatility, the incremental spread/yield offered by these higher-quality high yield issues may provide some cushion to investors. In rising rate environments, higher-quality high yield offers strong outperformance potential relative to investment grade credit while still providing minimal default risk over lower-rated credit. These characteristics of higher-quality high yield become particularly relevant and attractive as investors face a period of rising interest rates, including the potential for the U.S. Federal Reserve to accelerate the pace of its rate hikes. For example, when 10-year U.S. Treasury yields rose more than 100 basis points (bps) over 3-month, 6-month, 9-month, and

12-month time periods, global BB/B high yield showed consistently strong outperformance over investment grade credit (see **Figure 7**).

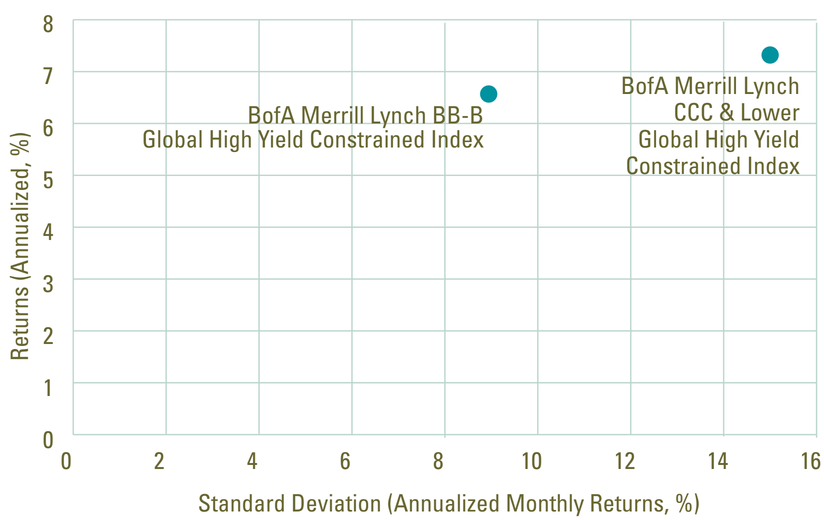
2. **Attractive total return with lower volatility.** Selective investing in global BB/B-rated bonds is an attractive way to earn income and total return with lower volatility relative to lower-rated credit (see **Figure 8**). Investors can participate in the upside potential without incurring significant default risk.
3. **Lack of structural constraints and illiquidity premia.** While the changing regulatory environment following the Global Financial Crisis has led to bank deleveraging and constricted access to capital, it also has created new opportunities for investors, including direct lending. These new products have helped to fill a gap created by the stringent post-crisis regulations, with private lenders affording middle-market enterprises access to capital no longer available through traditional loans. However, while these unconventional products may lure yield-seeking investors with the potential for sizable returns and low correlations to other asset classes, they also come with significant structural constraints, such as lock-up periods, price volatility, lack of availability or restricted access, and the potential need for investment specialists—all necessitating sizable illiquidity premiums. Certain qualified investors may benefit from these illiquidity premiums, but they typically must also be able to comply with regular lock-up periods and other constraints that considerably restrict access to principal. And as with any investment, loss of principal is possible.
4. **Price transparency and historical performance.** Furthermore, alternative investments such as direct-lending mandates are characterized by limited price transparency. These illiquid assets are not marked to market nor are they actively traded. These products are relatively untested, with no track record through various rate environments or economic climates, including recessionary conditions. Conversely, high yield, particularly higher-quality high yield, offers investors relative safety in the form of robust liquidity, transparency, and a time-tested understanding of historical performance, while still providing attractive risk-adjusted return potential.

Figure 7 Annualized Returns over Various Time Periods when U.S. 10-Year Treasury Yields Increased More Than 100 bps %, 1/1/1999 to 12/31/2016



Source: Bank of America Merrill Lynch, Bloomberg L.P., Brandywine Global

Figure 8 Higher Quality High Yield Has Provided Attractive Returns with Lower Volatility 1/1/1999 to 12/31/2016



Source: Bank of America Merrill Lynch, Bloomberg L.P.

CONCLUSION

The actions of central banks since the Global Financial Crisis have pushed yield-starved investors further down the quality spectrum into distressed investments, long/short strategies, and direct-lending mandates. As a result, the traditional investment grade/high yield barbell, where the relative safety of investment grade credit is offset by the increased risk and yield potential offered by a corresponding weight in high yield, may need to be revisited. With traditional high yield managers increasingly venturing into CCC and lower, investors may end up reaching for too much default risk or further down the liquidity rabbit hole. And, as some investors add private credit to their investment mixes, there is a potential for significant overlap in default and liquidity risks. For investors seeking incremental yield in the current low rate environment, but with less price volatility than associated with either the equity market or the lowest-quality segments of the high yield market, or with better transparency and liquidity risk than private credit, BB/B-rated global high yield bonds may offer an attractive risk-adjusted return opportunity. Furthermore, given the expectations for ongoing volatility and uncertainty in global credit markets, a flexible investment strategy and an experienced global manager may offer opportunistic exposure and the ability to successfully navigate different economic and credit cycles, providing the potential for superior risk-adjusted returns in higher-quality global high yield.