High-yield bonds have recently offered investors a high margin of additional yield relative to Treasury and investment-grade corporate bonds. This spread has been near its historical high and well above its long-term averages, presenting especially attractive current income potential in today’s low-rate environment. Any future spread contraction may offer the potential for price appreciation and capital gains. However, the current recessionary environment poses a heightened risk of default, underscoring the importance of security selection and intensive analysis of underlying fundamentals.

**ORIGINS OF TODAY’S UNIQUE MARKET CIRCUMSTANCES**

To understand the opportunity in the high-yield market today, it may help to recall one of the essential concepts of a bond investment — how the level of a bond’s yield compensates the investor for the assumption of risk.

The risk-free rate is the base rate that an investor earns from a bond that has no ascertainable risk of income failure or repayment delay. A good example of risk-free in this context is bonds issued by the U.S. Treasury and backed by the full faith and credit of the government of the United States. For practical investment applications, U.S. Treasury bond and note yields are generally recognized as the benchmark risk-free rates in the U.S. market.

Those who invest in bonds other than those issued by the U.S. Treasury generally assume various types of additional risk. Default risk is the chance that the bond issuer will find itself unable to make one or more interest payments, or more severely, may not be able to return the investor’s principal when the note or bond matures. Valuation risk can result if an issuer’s financial condition changes over time, which will result in price volatility. Inflation risk is the probability that inflation will reduce the value of future principal and interest payments. To be compensated for these risks, investors receive what is called a risk premium in addition to the risk-free rate. The size of the premium tends to be proportionate to the market’s perception of the degree of additional risk.

On any given day, each bond’s current market yield reflects the market’s assessment for each of these risks. From day to day, the market’s price for each unit of risk varies in relation to new information that is introduced into the market.
For most of the past five years, yields on various classes of long-term bonds tended to Hew closely to historical averages and the spread of yields between high-risk and low-risk bond categories remained stable. But when the credit markets turned volatile in September 2008, the market demanded much higher yields from speculative borrowers, and it accepted much lower yields from the low-risk U.S. Treasury. The result was a gap in yields of unprecedented magnitude. (This chart displays the yield history for bonds rated BB, which is the highest rating in the speculative range. The pattern of yields for BB bonds may be considered indicative of the trends shown by lower-rated bonds as well.) Past performance is no guarantee of future results.

Source: Standard & Poor’s.

On one side of the yield model, the yield that the market expected for its risk-free rate declined sharply as investors sought the safety of U.S. Treasury bonds during the market turmoil of 2008. The resulting price increase brought down the yields on U.S. Treasury bonds. The yield decline was supported by unprecedented measures taken by the Federal Reserve to boost investor confidence and stimulate the economy.

At the same time, the risk premium that the market demanded for lower-rated corporate bonds spiked sharply due to pervasive selling pressure, economic uncertainty, and heightened wariness about hidden risk factors in many types of debt securities.

Since reaching their record extremes at the start of 2009, both the speculative and the risk-free rates have edged back somewhat toward their historical norms. But continued uncertainty about business conditions and the ongoing efforts at economic stimulation have continued to support historically widespread levels.

**FUNDAMENTALS REMAIN KEY**

Officials at the central bank will likely phase out financial support and stimulus programs. The damage to the financial system from the subprime meltdown will be resolved as the full extent of collateral losses becomes recognized. Once systemic risk declines, the fundamentals of credit performance, the business climate, and inflation should be the primary factors that drive bond prices.
Chief among these is credit risk — factors that pertain to the financial health and resources of the bond issuer — how much money is on hand, how much can be expected to come in from continuing operations and asset sales, how much must be paid out to support those operations and acquire new assets, and how much must be paid out to meet debt obligations and provide returns to shareholders. Companies with more-than-adequate cash reserves and above-average business prospects are likely to be accorded higher ratings.

Lower ratings are generally in proportion to the degrees of risk found — with lower ratings typically associated with higher levels of credit risk. For example, among bonds at the top quality tier of the Standard & Poor’s bond rating scale (AAA), there were no observed defaults between 1981 and the end of March 2009. Among the other classes of investment-grade bonds, default risk during the period was barely measurable.

In the high-yield range, bonds at the top of the range (those rated BB at the time of default) showed a default rate of just less than 1%. However, among bonds carrying the lowest ratings of CCC, CC, or C, the rate was more than 25%.

Of course, company circumstances change, as does the business environment. Economic recessions stress weaker companies the most. Default rates have historically increased during recessions and declined during the subsequent economic recoveries. The prospect of future inflation tends to drive up yields as investors demand higher interest payments in order to help protect their future purchasing power. Sometimes referred to as inflation risk, this increasing concern about inflation tends to drive down prices for existing bonds.

**HIGH-YIELD DEFAULTS VARY WITH THE ECONOMIC CYCLE (RECESSSION PERIODS ARE SHADED)**

Historically, speculative bond defaults have tended to rise as the economy slows then decline as the next upswing in the economy begins.

Source: Standard & Poor’s Credit Market Services default and transition studies. Recessionary periods are defined by the National Bureau of Economic Research’s Business Cycle Dating Committee.
DEFINING THE OPPORTUNITY

There are two components of return in high-yield bonds — income and capital gains. Consider first the income potential. At the middle of May 2009, the average 25-year term corporate bond with a BB-rating was priced to yield investors an annual interest rate approximately four times greater than was available from a U.S. Treasury bond of comparable term. That contrasts sharply with the market condition that had prevailed for much of the previous five years, when the average yield for a BB-rated bond of that term was less than double the comparable Treasury.

In addition, a bond’s current market value has an inverse relationship to the market yield. An existing bond gains market value when rates decline as the price adjusts to reflect the required yield at the stated coupon. Yields in the high-yield market are currently elevated relative to historical norms. Thus, if the market were to return to its historical equilibrium, prevailing bond yields would be expected to decline resulting in higher bond market value. This assumes that economic recovery ultimately reduces credit risk from environmental factors, that general business conditions improve, and that inflation remains muted.

High-yield investing holds an elevated risk of loss due to default. As noted previously, the historical risk of default on the highest-quality speculative bonds is only slightly elevated from the norms of the investment-grade universe. However, risk increases sharply as a company slides down the ratings scale. Managing that risk effectively requires that an investor monitor the company closely to detect early warning signs that the issuer may be losing its financial strength and, if necessary, liquidating the position before serious credit deterioration sets in.

Speculative bonds with higher initial ratings tend to have had lower default rates and reach their peak default years later than bonds with lower initial ratings, based on an analysis of all rated issuance between 1981 and 2008. Bonds that had been downgraded prior to their default were counted as part of their original rating group, not as part of their rating group at the time of default.

Source: Standard & Poor’s Credit Market Services.
One other important factor for an investor in the high-yield market to consider is portfolio management. Generally speaking, only large portfolios can be diversified effectively. Given that individual bonds often carry face values of $10,000 or more, viable diversification can be out of reach for all but the largest bond portfolios. Furthermore, risk management requires continuous news monitoring and frequent reevaluation of the business prospects and corporate finances of each bond issuer represented in the portfolio. For many individuals, the intensity of this effort can be prohibitive. The alternative is a professionally managed bond fund, especially one that focuses on the prime sectors of the high-yield market. A professionally managed fund can offer individuals access and support in the potentially rewarding high-yield marketplace.

Northern Trust Investments manages diversified portfolios that combine top-down macroeconomic and market views with rigorous bottom-up fundamental analysis. Portfolios are managed with a consistent risk management process to capture current yield and price appreciation. We believe this approach complements other styles of investing and may play an important role in a well-rounded portfolio.

For additional support in supplementing your clients’ fixed-income exposure, please contact your Northern Trust Investments Regional Manager or our Advisor Consulting Group at 877-867-1259.

Important Considerations:

There are risks involved in investing, including possible loss of principal. There is no guarantee that the investment objectives of any fund or strategy will be met. Risk controls and models do not promise any level of performance or guarantee against loss or principal.

Bond Risk: bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issue and in environments of rising interest rates.

High-Yield Risk: Although a high-yield fund’s yield may be higher than that of fixed-income funds that purchase higher-rated securities, the potentially higher yield is a function of the greater risk that a high-yield fund’s share price will decline.

Diversification alone does not guarantee a profit nor protect against a loss.

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