

Talking Points

Insights From Morningstar's Fund Analysts

The High-Yield Dilemma

Quotable

While we acknowledge that in the near term a supportive Federal Reserve and modest economic growth are likely to keep default risk low, we are surprised at investors' willingness to drive the high-yield market yield to such lows. Over the longer term, we believe that current yields may prove to be inadequate compensation for rising rates ...

Michael Hong
Vanguard High-Yield Corporate VWEHX

Although the credit cycle is still moving along, near-record profit margins are at risk given rising commodity costs, higher Treasury interest rates, improving job conditions (albeit slowly) and perhaps less monetary assistance from the Fed. Excess returns are likely to be favorable; however, absolute returns might be range bound going forward.

Gino Nucci
Metropolitan West High Yield MWHYX

The Issues

High-yield corporate-bond mutual funds have surged in popularity so far in 2011. They took in an estimated \$9 billion in the first quarter, which already surpasses the category's \$7.6 billion intake in 2010.

Are investors too late? The heady gains of the past two years are over for now. With the Barclays Capital U.S. High Yield Index's average price at \$104 currently, there's very little room for prices to rise further (see below). The sector's potential income returns also appear muted: The Barclays index's 6.8% yield is near the low end of its historical range. The last time the index was priced above \$103 was early 2005, when it also yielded less than 7%. That year, the typical high-yield bond fund returned just 2.6%.

But even though absolute yields look low today, high yield still has some appeal relative to high-quality bonds. The yield gap between the average junk bond and Treasuries is currently around 5 percentage points, which is just below the long-term average. The extra yield cushion that junk bonds offer over Treasuries can blunt the impact of rising Treasury yields. The sector demonstrated its resilience during the recent November 2010 to January 2011 Treasury sell-off, for instance.

That diversification argument still has merit, but today's low absolute yields and limited upside hardly signal an attractive entry point.

The Points

- ▶ The percentage of high-yield bonds that include call features has risen over the past year, further constraining the sector's return potential. Call options limit how high bonds' prices can go because they allow issuers to call their bonds when they're trading at a premium and refinance into cheaper rates.
- ▶ Strong investor demand for high yield also allows companies to issue bonds on less bondholder-friendly terms. Roughly one fourth of leveraged loan issuance in 2011 has come to market without the usual covenants that provide borrowers early protection against deteriorating fundamentals. Plus, although the majority of high-yield issuance in the past two years was used for refinancing, an increasing amount of new issuance is financing acquisitions, adding leverage to balance sheets. A few egregious examples of lax underwriting--such as buyout firm KKR's takeover of Del Monte Foods, which co-founder Henry Kravis extolled as "the most attractive financing (the firm) has ever done"--underscore the increasing need for careful credit selection.
- ▶ But is it too soon to get bearish? Many fund managers remain optimistic about high-yield fundamentals, which could support the sector over the next 12 to 18 months. PIMCO High Yield's PHYDX manager Andrew Jessop notes in a recent commentary that roughly 40% of the total outstanding global high-yield market was issued since the start of 2009, as companies refinanced bonds set to mature in the next couple of years. As a result, most high-yield companies won't face the pressure of having to pay down or refinance existing debt for another several years. In turn, that has caused the corporate default rate to very quickly drop from its 2009 highs to near all-time lows; PIMCO and others expect a 1% annual default rate at the end of 2011. At the same time, he points out that recovery rates have also risen substantially. In recent default workouts, investors have recovered an average of 60 cents on the dollar, compared with 20 cents in early 2009.