Even though high-yield bonds look like other bonds, they don't necessarily act like other bonds.

Gershon Distenfeld, CFA
Senior Vice President and Director—High Yield

Ashish Shah
Senior Vice President and Portfolio Manager—Global Credit

High Yield: Equity-Like Returns…with Half the Risk?

Investors often think of high-yield bonds as simply another component within a fixed-income allocation. But strong risk-adjusted return potential and a low correlation to other investments may argue for giving high yield its own seat at the asset-allocation table.

Today's fixed-income landscape features a dizzying array of securities, from US Treasury bills to corporate bonds, and from mortgage pass-through securities to catastrophe-linked bonds. On the surface, high-yield bonds seem a lot like their fixed-income relatives: they represent loans from investors to an entity, make regular coupon payments and commit to repay investors in full on a specified maturity date.

It's not surprising, then, that investors tend to think of high yield as a component within their bond allocations. Given that high yield is one of the riskiest fixed-income sectors, many investors adjust their high-yield allocations in order to raise or lower the overall risk in the fixed-income component of their portfolios.

Looks Are Deceiving

But even though high-yield bonds look like other bonds, they don't necessarily act like other bonds. This insight can have important implications for how investors consider them in an overall portfolio context.

High-yield performance patterns, for example, don't track those of other fixed-income sectors very closely over the long term. Looking back almost 30 years, US high-yield bonds have exhibited a correlation of only 0.22 to a broad universe of investment-grade bonds, and a correlation of 0.14, to US Treasury bonds, the traditional bellwethers of the US bond market.[1] Of course, these correlations aren't constant—they fluctuate substantially over time. Based on a rolling three-year average, high yield's correlation to US Treasuries has ranged from as low as –0.09 to as high as 0.41.

High yield's long-term correlation to US stocks, as measured by the S&P 500 Index, has been 0.61; to global stocks, as measured by the MSCI World Index, it's been 0.60. These correlations show clearly that high-yield bonds have tracked stocks more closely than they've tracked bonds.

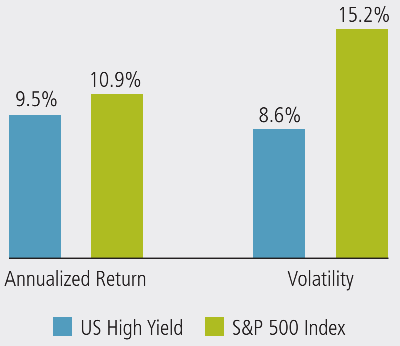
Why is this? High-yield bonds, like equities, are strongly linked to the business results and fundamentals of the companies they represent. And credit spreads, the incremental yield that high-yield bonds offer versus same-duration government bonds, tend to move inversely with interest rates. This leaves high-yield bonds generally insensitive to interest rates—the dominant risk factor for many investment-grade bond sectors.

This sensitivity, however, isn't constant over time. It's typically greater when high-yield spreads are lower—correlation is positive, although modest. When yield spreads are wider, on the other hand, the correlation is often negative.

[1] US high-yield bonds are represented by the Barclays US Corporate High-Yield 2% Issuer Capped Bond Index; US Treasury bonds by the BofA Merrill Lynch Current 5-Year US Treasury Index; and investment-grade bonds by the Barclays US Aggregate Bond Index.

Display 1: High-Yield Bonds—Strong Returns, Less Volatile than Stocks

Historical Performance, July 1983–December 2013



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
US High Yield is represented by the Barclays US Corporate High-Yield 2% Issuer Capped Bond Index.
Source: Barclays, Bloomberg, S&P and AllianceBernstein

This is important, because the last few years of record-low interest rates have increased the popularity of high-yield bonds, compressing spreads to below their long-term historical average. A rapid increase in interest rates could cause high yield to underperform equities.

Tighter spreads can make valuations less compelling, and might moderate returns in the short run. But they don't, in our view, diminish high yield's ability to diversify portfolios and improve the consistency of returns over longer time frames.

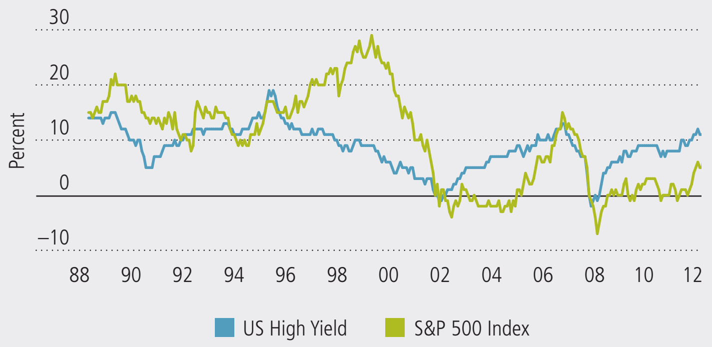
Keeping Pace with Equity Returns over Time

In fact, when we widen the lens to take in the last three decades, high-yield bonds have nearly matched equity performance. And they've done it with much lower volatility.

Since July 1983, stocks have produced an annualized return of 10.9% (*Display 1*). High-yield bonds have nearly equaled that performance, with a 9.5% return over a period spanning two full market cycles as well as countless rallies and sell-offs.

Display 2: Equity Returns Outpace High-Yield Bonds at Times

Rolling Five-Year Annualized Returns



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
Through 31 December 2013
US High Yield is represented by the Barclays US Corporate High-Yield Index.
Source: Barclays, Bloomberg, S&P and AllianceBernstein

The two asset classes can't be compared over a longer time frame because earlier high-yield index returns don't exist. But the 10.9% annualized return for stocks is roughly on par with performance dating back to 1927, so these performance patterns appear to be fairly consistent over time.

High-yield bonds haven't always kept up with stocks—they've been outpaced handily over certain time frames (*Display 2*), such as when the technology/media/telecom bubble was inflating in the second half of the 1990s. But over the long haul, high yield has produced equity-like returns—with about half the risk of stocks, as measured by the standard deviation of returns.

In fact high yield's volatility has been consistently lower than that of stocks (*Display 3, next page*), even through some tumultuous periods for capital markets. These attributes, combined with relatively low correlations to stocks—and very low correlations to other bonds—have made high-yield bonds effective within a diversified portfolio.

A Place at the Asset-Allocation Table

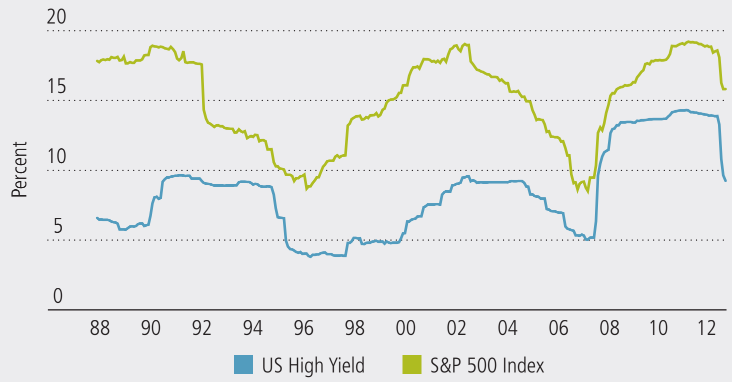
For investors seeking to control volatility in their equity portfolios while still maintaining return potential, high-yield bonds could represent an effective solution.

A typical approach to moderating equity volatility is to reallocate assets to the greater stability of investment-grade bonds, or even cash. But this can exact a heavy cost in sacrificed return potential. High-yield bonds, on the other hand, can help investors reduce risk without sacrificing much return.

Doesn't this make the case that high-yield bonds deserve their own place at the table in portfolio discussions? Investors might want to consider taking a different perspective on asset allocation: instead of asking how much bond

Display 3: High-Yield Bonds Have Historically Had Consistently Lower Volatility

Rolling Five-Year Annualized Standard Deviation



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
Through 31 December 2013
US High Yield is represented by the Barclays US Corporate High-Yield Index.
Source: Barclays, Bloomberg, S&P and AllianceBernstein

exposure should be allocated to high yield, perhaps they should ask how much equity exposure should be allocated to high yield.

Historically, answering that question with a significant allocation to high-yield bonds—rebalanced quarterly—would have been a highly productive decision. Investors would have been able to substantially reduce overall portfolio volatility in exchange for only a minimal reduction—if any—in annualized returns.

As mentioned earlier, from July 1983 through December 2013, the S&P 500 Index produced a 10.9% annualized return, with annualized risk of 15.2%. A portfolio mix of 75% equities and 25% high yield, on the other hand, would have lowered annualized risk to 12.8%, with nearly the same annualized return (*Display 4*). And that's with a sizable allocation to a high-yield asset class that returned slightly less than equities over this time period. How is this result possible?

Rebalancing in the Tails

Because stocks have been so much more volatile than high yield, periodic portfolio rebalancing tends to occur during performance extremes—the "tails" in return distributions—when the gap between high-yield and equity returns is wide. This magnifies the "buy-low, sell-high" effect that rebalancing contributes to a portfolio's performance. Of course, the gaps between returns on stocks and investment-grade bonds would also be sizable if those two classes were paired in a portfolio, but investment-grade bonds wouldn't contribute as much performance potential as high yield.

Over the same time period referred to in the earlier example, investors could have split their portfolio 50/50 between stocks and high yield. This would have slashed volatility from 15.2% to 10.7%—while allowing investors to still nearly match the 10.9% annualized hypothetical equity return.

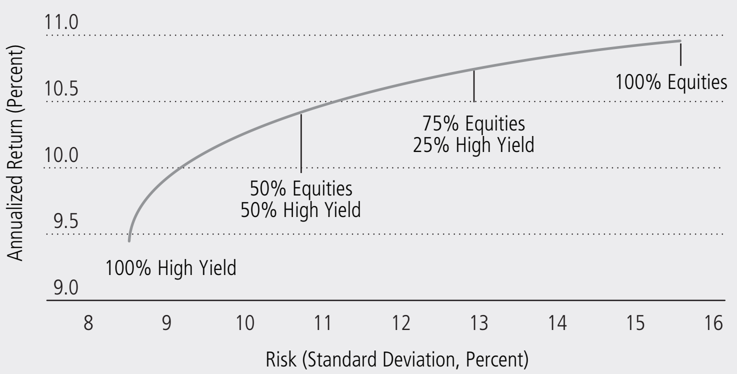
High Yield in the Portfolio Framework

Given their higher risk levels, we'd expect that stocks would continue to outperform high yield over the long run. However, high-yield bonds have clearly demonstrated that they bring much to the table if they're combined with stocks in a carefully designed and maintained portfolio.

But not every investor will be comfortable with 50%, or even 25%, of equity exposure allocated to high-yield bonds. Investors must define a portfolio allocation that's appropriate based on their specific goals and risk tolerances. Also, demonstrating that high-yield bonds are effective in a diversified portfolio doesn't imply that investment-grade bonds won't be effective too.

Display 4: High Yield and Stocks Combined—Better Risk-Adjusted Return Potential

Hypothetical Annualized Risk and Return, July 1983–December 2013



Diversification does not eliminate risk of loss.
Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
High Yield is represented by the Barclays US Corporate High-Yield Index. Equities are represented by the S&P 500 Index.
Source: Barclays, Bloomberg, S&P and AllianceBernstein

High yield's merits, however, should prompt investors to think twice before they stereotype it as simply another element within a portfolio's fixed-income exposure. Many investors rely on bonds to dampen the volatility of their equity portfolios, so they're naturally reluctant to give their investment managers too much flexibility in allocating to below-investment-grade bonds. That's because high-yield bonds are admittedly among the most volatile fixed-income asset classes. But they've also been much less volatile than stocks.

Are Rising Rates a Risk?

Investors thinking about introducing high-yield bonds into an asset allocation might ask if it's the right time to invest in them. With interest rates at historic lows, won't there be substantial risk to high-yield bonds when rates begin to rise again?

It's a fair question, and there are risks investors should be aware of. As we stated earlier, high-yield bonds' sensitivity to rising rates is at its greatest when credit spreads are narrow. And over the last few years, high demand from investors struggling to find yield in other bond sectors has caused spreads to shrink considerably, and dip below their historical average.

It's certainly possible that a rapid increase in economic growth could lead high-yield bonds to be more sensitive to rising interest rates than our historical analysis indicates. In that scenario, we'd expect high-yield bonds to underperform equities.

On the other hand, a more modest rate of growth—the sort of steady but subdued expansion we've seen for several years now—should enhance high yield's appeal.

Tighter high-yield spreads also mean that most returns will likely come from high yield bonds' regular coupon payments. It's worth pointing out that this wouldn't be a big departure from 2013, when high-yield delivered a total return of 7.4%, with an average coupon of 7.3%.

Most importantly, we think that the decision to add high yield to an asset allocation should be based on a long-term portfolio-construction perspective. On that score, high yield retains the ability to dampen portfolio volatility without sacrificing much in the way of returns.

Is This a Global Story?

In our view, designing a high-yield allocation today should involve a global perspective.

Our analysis focuses on US high-yield bonds, in large part because this market provides a lengthier historical data set than other high-yield markets do. But the global market for high-yield bonds continues to expand and evolve: European high-yield bonds, for instance, have become a growing market, and have been aided by the launch of the euro currency.

We believe that investors can access even greater diversification and flexibility in a high-yield allocation by looking across borders and incorporating not only high-yield bonds, but sectors such as emerging-market debt—sovereign and corporate—and other fixed-income securities that offer potential for high income. This unconstrained approach provides greater flexibility in optimizing a high-yield allocation.

Summing It Up

High-yield bonds present an alternative for investors at an uncertain crossroads. Equity valuations seem attractive based on some measures, but volatility has led many investors to search for ways to temper the risk in their portfolios. At the same time, bonds—a popular risk reducer—are less attractive than normal due to extremely low yields.

High yield's strong risk-adjusted return potential and complementary nature to both stocks and investment-grade bonds argue for a different perspective. Instead of stereotyping high-yield bonds because they "look like bonds," our research suggests that investors should consider high-yield bonds as a worthy replacement for part of a portfolio's equity exposure—or even as a stand-alone allocation distinct from stocks and bonds. ■

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