



MARKETS

# Five ways to capture returns from the high yield bond market

While high yield bonds have recovered sharply from a difficult start to the year, there are still a number of ways that investors can capture compelling value.

26/05/2016



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**30 Minutes**  
Unstructured  
Learning Time

In January and early February markets suffered one of the worst starts to a year in history, and credit spreads<sup>1</sup> in high yield bonds<sup>2</sup> widened aggressively.

In March and April however, sentiment recovered sharply and credit spreads were squeezed tighter again. Valuations in European and US high yield are now closer to long-term averages again.

## Relative value opportunities

We believe that even with high yield trading closer to fair value, investors should still be well compensated for holding these bonds through short-term volatility.

Furthermore, there are still ways to capture relative value if investors look across currencies, sectors and ratings categories.

Below are just a few examples of how to capitalise on current market dislocations.

- High yield bonds in the BB rating bracket offer very attractive value compared with investment grade BBB rated bonds as the European Central Bank's (ECB) asset purchases now include non-financial BBB rated European corporate bonds. Despite lacking the direct support of a price-insensitive buyer, we believe that BBs should see a "trickle down" effect of the ECB's activity.
- Financials have lagged non-financials in the opening of 2016 with the insurance sector, in particular, having struggled. An element of this underperformance is due to concerns surrounding capital market exposure, with a range of big European banks reliant upon access to capital markets to generate profits. If these markets are closed, profit margins can suffer, but we feel that the worries surrounding the theme may now have gone too far.
- Credit spreads in the US are materially wider than in Europe, and some sectors of the US market are starting to look attractive on a relative basis comparing similarly-rated credits. This comes with the important caveat that overall US debt levels (or leverage) are much higher than in Europe as reflected in the proportion of lower-rated credits as the percentage of the market. The US is further along the credit cycle<sup>3</sup> and as a result, merger and acquisition activity has risen and leverage has climbed. While we are happy to selectively add to US high yield, we do so with this leverage difference very much front-of-mind.
- After a sharp rally in commodities there are still some remnants of value. We look for those companies which can survive and prosper in a world of low energy prices; where yields remain elevated, we are happy lending to those metal and mining companies that

do not require a rapid rise in commodity prices.

- We would expect US interest rates and government bond yields to rise over the next 12 months as services sector inflation is above 2.5% p.a., some energy prices have already risen by over 50% and the Fed is patently behind the curve. With potentially higher interest rates, certain sectors like banking should benefit, whilst others, such as property, may struggle.

## High yield offers diversification benefits

With the market looking fairly valued, finding the most compelling way to gain access to high yield bonds is challenging, but there are still opportunities.

Investors should also remember that from a strategic perspective, high yield bonds could offer solid returns and important diversification benefits irrespective of the short-term market backdrop.

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1. The yield spread is the difference in yield between different types of bonds (for example, between government bonds and corporate bonds). Credit spread denotes the difference between corporate bonds and government bonds. ↩

2. A high yield bond is a speculative bond with a credit rating below investment grade. Investment grade bonds are the highest quality bonds as assessed by a credit ratings agency. To be deemed investment grade, a bond must have a credit rating of at least BBB (Standard& Poor's) or Baa3 (Moody's). Generally, the higher the risk of default by the bond issuer, the greater the interest or coupon. ↩

3. A credit cycle denotes the changing access to credit by borrowers over time. Credit cycles typically start with a period in which funds are easy to borrow; characterized by lower interest rates, lowered lending requirements and an increase in the amount of available credit. These periods are followed by a contraction in the availability of funds. During the contraction period, interest rates climb and lending rules become stricter, meaning that less people can borrow. ↩

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