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Curves (part 6) – provider of yields

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Have you ever been to a Californian beach? If you have, you may have noticed the hoards of “searching”, elderly people. They would usually be holding a metal rod that beeps, looking for valuables that no-one else has found. And sometimes somebody finds a lost golden watch on the beach. But most of the time the things that turn up are only worthless beer caps.

Investors on the interest rate market are in a similar situation. They are always looking for higher yields. In this article, we would like to look at a market that, by comparison with other markets, currently offers high yields: the US high-yield bond market. In the current environment, it constitutes an interesting investment opportunity (albeit at commensurate levels of risk). We are mostly interested in the spreads.

US high-yield – a place to be?

Bonds with lower ratings, i.e. from BB+ onwards and below, are regarded as high-yield (or non-investment grade). Investors should be aware of the fact that these bonds are investments that have a high to very high degree of risk associated with them. In compensation for this higher risk, the bond offers higher yields or higher spreads (in comparison with government bonds of the same maturity).

US high-yield market, yield and spread

The market for US high-yield bonds consists of hundreds of different issuers. Therefore, we are going to look at the market data on the basis of a representative index as opposed to an individual market.

- The chart shows the yield of the US high-yield market, which is currently at 6.07%. The yield is clearly subject to significant fluctuations over time.
- As part of the market yield, the yield of the safe US Treasury bonds (5Y) were inscribed. This yield is currently at 1.81%.
- The difference between the credit-safe yield and the risky alternative is called risk premium or spread. It is currently 4.26% (= 6.07% – 1.81%). The spread also fluctuates over time.

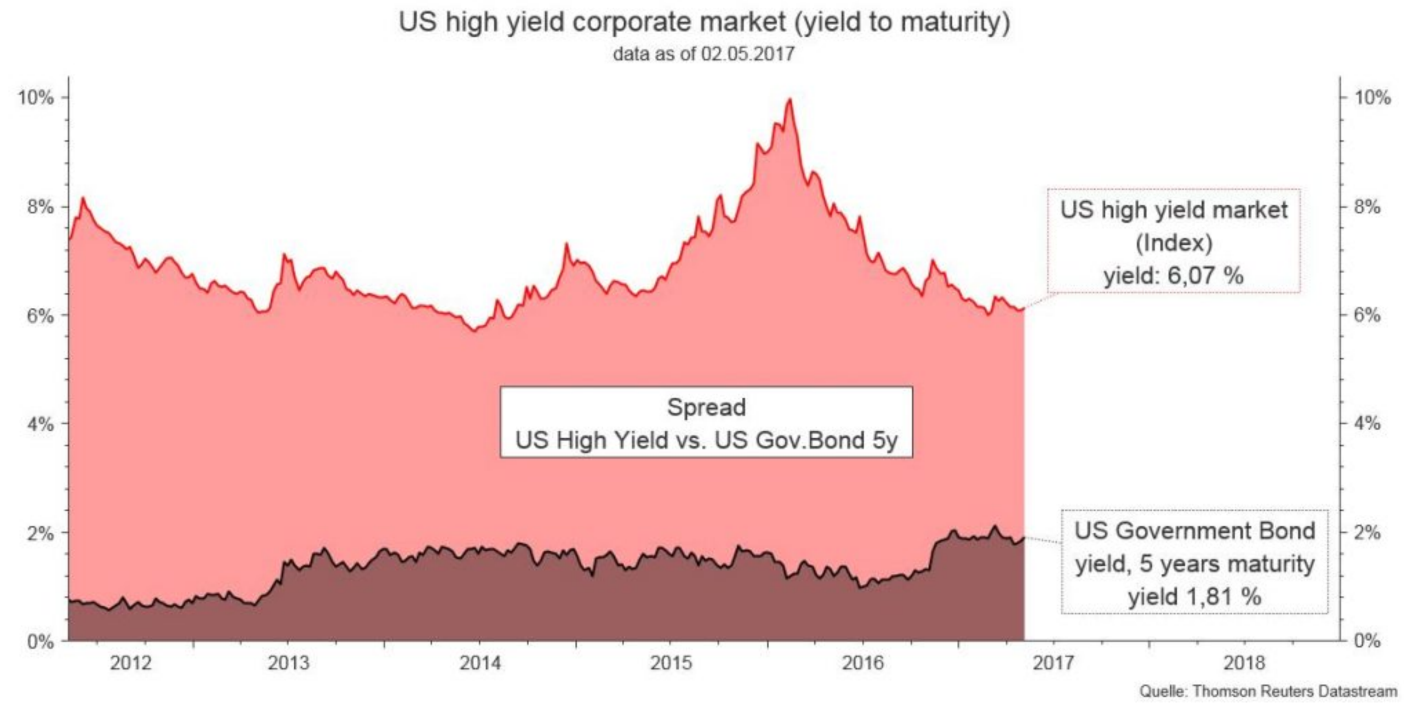

Chart: Yield US corporate bonds high-yield segment as compared to the US Treasury bond with 5Y remaining time to maturity Interest rate differential (i.e. spread), observation period 5 years Sources: Datastream, as of 2 May 2015

Does the spread compensate for the risk?

Under the assumption that investors act rationally, we can do a simple calculation for the advantageousness of a possible investment alternative:

The credit-safe bond (US Treasury) serves as basis. Given that it cannot default by definition, the return of a bond (for example 5 years for a bond with 5Y remaining time to maturity) can be calculated. A risky investment (over the same period of time) is preferable if the return is higher (taking into account possible defaults).

- The question is therefore: “Does the spread compensate for the volume of defaults?”

A simple question that is not easily answered, because the yield of the security is calculated on the basis of its end of maturity under the assumption of redemption at 100%. However, defaults are a common occurrence in the high-yield segment. This occurrence will happen in the future – which is uncertain.

The different assessment by investors of future developments is what makes this market so exciting – with the accordingly high degree of volatility.

A practical example: the tasks of a fund manager

In an investment market where defaults are to be expected, a wide degree of diversification is a must. Unfortunately one cannot predict which bonds will be defaulting. But one relation is clear: the lower the rating, the higher the probability of a default.

This means that one should not just select the bond with the highest yield. The following chart shows the yields of US corporate bonds by rating.

The “HY Total” bar to the right shows a yield of 6%. This is also in line with the chart further up. Alongside, we have the segments “BB”, “B”, and “CCC or lower”. If one were to only take into account the yield, one would have to choose the segment “CCC or lower”, which currently offers a yield of above 10%.

When selecting the issuers, the fund manager has to ensure a sufficient level of diversification with regard to

- Rating
- Maturity
- Sector/region

This means that the fund manager contributes his/her specific know-how and optimises the portfolio with regard to return and risk. A fund that invests in US high-yield bonds may contain 300 or more individual titles, given the relevance of broad

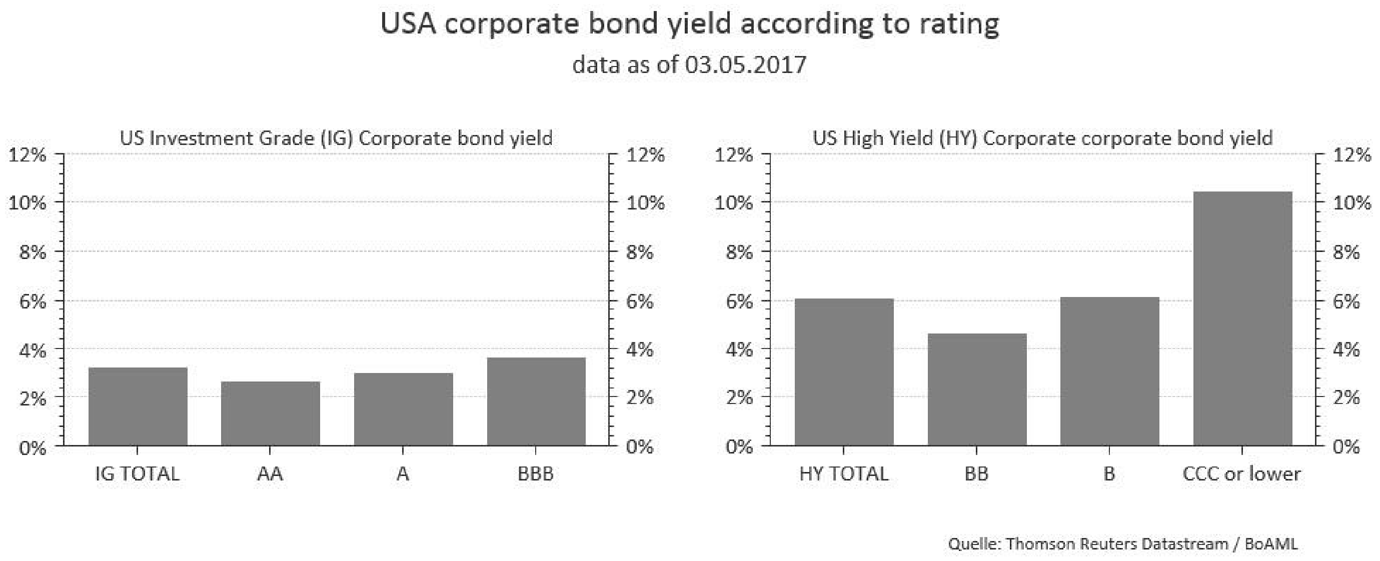

Chart: yield of US corporate bonds investment grade (left) vs. high-yield (right) Source: Datastream, as of 3rd May 2017

diversification.

Why do investors need this information?

Investing in high-yield bonds requires know-how. Simply buying an individual bond with high yield is not the optimal route due to its likelihood of a default. Interested investors should ideally invest in this segment by way of a broadly diversified investment fund.

Conclusion:

One could indeed go out and look for deals with a “yield detector”. But you will only find something extraordinary where nobody else has looked – and on the financial markets, there are loads of people looking alongside you. Do not get blinded by yields, because behind every higher yield you will find a higher level of risk. A broadly diversified fund might be the solution for many investors in this segment.

Diversification is part of the active management of funds at Erste Asset Management. For more information about the range of products of Erste Asset Management, please visit our homepage at www.erste-am.at

Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of ERSTE-SPARINVEST, Ringturm, and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The “1x1 of Investment Funds” that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on “banks” and “securities”. After completing his master’s degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: “Only a day with laughter is a good day”