High-yield bonds – a look behind the scenes

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In the context of record lows of money market rates and low government bond yields, high-yield bonds remain in demand. In view of the already very low spreads it may be worthwhile having a closer look at this bond segment.

Ratings – what do they tell us?

Corporate bonds are rated by rating agencies such as Standard & Poors or Moody's. The scale of rating classes ranges from AAA/Aaa (excellent) to D (default). High-yield bonds are bonds with ratings of BB, B, CCC, CC, and C. The investor assumes a higher default risk when investing in these bonds, but he/she receives a higher coupon/yield in return. Hence the term "high-yield bond".

The historical default rates differ very much from each other, depending on the rating. For example, 15.1% of B-rated euro corporate bonds in the market index[1] have defaulted in the past five years[2], whereas only 5.7% of BB-rated bonds have defaulted.

[1] BofAML Euro High Yield Index, as of 14 December 2017

[2] Sources: ERSTE SPARINVEST on the basis of Deutsche Bank, S&P, Markit Group, default rates from each respective monetary union, cumulated over five years. As of 19 April 2017.

At the moment, the average annual yield to maturity of ESPA BOND EUROPE HIGH YIELD is 2.93%, and it is 6.48% for ESPA BOND USA HIGH YIELD.* Although at this point one has to deduct about 2% in costs for permanent hedging of the US dollar vis-à-vis the euro for ESPA BOND USA HIGH YIELD, this segment is still more attractive than its European peer.

*Data as of 29 December 2017. Source: Erste Asset Management

Europe: stronger ratings, higher weighting of the financial sector

The USD yield is currently beating its EUR counterpart; which is normal, since interest rates are higher in the US dollar region. But there is another reason for this difference, because the structure of the two high-yield markets bears significant differences. For example, the average rating of EUR high-yield bonds is BB, whereas that of USD high-yield bonds is only B. The average rating quality of USD high-yield bonds is also below that of their EUR peers. This is due to the sector allocation. In Europe, banks, telecoms, and utilities dominate the bond market, whereas in the USA the – in qualitative terms – weaker energy sector, industrials, and commodities play an important role.

What is the status quo?

Both in Europe and the USA, the economic upswing is intact. Profit margins have improved sustainably in particular among US companies, the most recent key balance sheet ratios are stable, and the levels of liquidity are sufficient[3]. According to IMF experts, the recently passed tax reform comes with a stimulating effect on the USA and its trading partners, at least temporarily.

[3] Source: Erste Group Research, Global Strategy, January 2018

Default rates are at historically low levels, and the forecast by Moody's dips even lower for the end of 2018.[4]

[4] Source: Moody's Monthly Default Update: Global Corporate Default and Recovery Rates, as of November 2017

Historic annual default rates. Source: Moody's Monthly Default Update: Global Corporate Default and Recovery Rates, as of November 2017

Diversification is key

By buying a high-yield bond, the investor assumes the default risk of an individual issuer. Spreading one's capital across a larger number of companies is important in order to avoid cluster risks. At the moment, ESPA BOND USA HIGH YIELD contains 456 bonds, and ESPA BOND EUROPE HIGH YIELD holds 168 bonds. This means that the funds offer a broad degree of diversification also for small investment sums. The risk is spread across many issuers, and the attractive coupons are reflected in the regular dividends distributed by the funds.

High-yield bonds: pros and cons

Opportunities

- Broad diversification across high-yield bonds
- Sustainably attractive investment segment
- Chance of high annual dividends
- Currency hedging, therefore no currency effects

Risks

- The share price of the fund may be subject to significant fluctuations
- Price declines are possible particularly in the event of widening spreads (i.e. worsening ratings)
- Average to low rating outside the investment grade segment, i.e. elevated risk of default
- Capital loss is possible

Legal note:

Prognoses are no reliable indicator for future performance.

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