The Rennie Quarterly Return

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High-Yield Bonds

Historic Yields (% through 11/30/15)

	1 Year	3 Years	5 Years	10 Years
VFIDX	2.9	3.2	3.6	4.5
VWEAX	5.2	5.7	6.3	7.2
Difference:	2.3	2.5	2.7	2.7

Annualized Total Returns (% through 11/30/15)

	1 Year	3 Years	5 Years	10 Years
VFIDX	1.9	2.2	4.4	5.6
VWEAX	0.1	3.7	6.5	6.4
Difference:	-1.8	1.5	2.1	0.8

Let's consider the following large corporations: T-Mobile, Sirius XM, Sprint, Hertz, CIT Group, Hospital Corporation of America, PetSmart, Dish Network. What do they all have in common?

You may be surprised to learn that the debt, or bonds, issued by these corporations is rated below investment grade by the major ratings agencies. This sector is often called "junk" bonds, or high-yield bonds.

Over the ten years ending in 2014, $10.8 Trillion of new bonds were issued by US corporations. Over $2 Trillion fell into the high-yield bucket. Over the same ten years, the average default rate on high-yield bonds was a meager 3.6%/year. It is even lower today.

Why invest in high-yield bonds? As the name implies, lower credit quality issuers must pay a high yield to attract bond buyers. This translates into more portfolio income for the investor.

How much more? We can compare the yields and total returns of two Vanguard mutual funds; VFIDX which holds only investment-grade corporate bonds, and VWEAX which holds only high-yield bonds. As the table shows, the yield on VWEAX exceeded the yield on VFIDX by a consistent 2.3% to 2.7% over the last ten years. For investors who need portfolio income, the yield difference is compelling.

However, the higher yield comes at the expense of relatively higher bond price volatility, as exhibited by the historic total returns for the two Funds. Clearly, over the long term, investors have been compensated for taking on the higher volatility and default risks.

The dichotomy between VWEAX and VFIDX is ideal for this exercise. However, many actively-managed multi-sector bond funds invest in both investment-grade and high-yield bonds, along with other debt instruments. The managers deftly apportion fund assets depending on the relative risk/return propositions they perceive.

We feel high-yield bonds have been unfairly maligned in the press lately. Some analysts point to a glut of issuance over the last several years due to historically low interest rates fueling investor demand. They see a "bubble" about to burst. In fact, high-yield debt issuance trails the growth seen in investment-grade bond issuance over the same time.

Other pundits point to a combination of rising interest rates and falling energy prices. These factors will cause more defaults, particularly in energy-sector high-yield bonds. This is not an unreasonable expectation. Interestingly, defaults were led by the technology and retail sectors in 2014.

However, the energy sector represents only a small share of the high-yield bond market. To confirm, we examined the largest 20 positions of three high-yield bond funds we frequently recommend, PHIYX, VWEAX, PRHYX, and the biggest high-yield ETF, HYG.

Of the 80 high-yield bonds we sampled, only 8 were issued by energy-related companies. A very broad swath of the global economy was represented, including sizable holdings in the corporations mentioned in our opening paragraph. As usual, the funds are extremely well diversified.

Finally, some see a "liquidity squeeze" if mediocre returns trigger high-yield fund redemptions. The same was said when Bill Gross's departure from PIMCO triggered unprecedented redemptions in the flagship PIMCO Total Return Fund. These fears were unfounded. PIMCO showed that good fund managers are excellent at generating fund liquidity when needed.

Data Sources:
Default data: Moody's Investor Service
Issuance data: SIFMA

Gary B. Rennie, CFP®, AWMA®
Chief Executive Officer
Phone/Fax: (949) 679-4775
Cell: (949) 769-1343
Email: gbrennie@cox.net

E. P. Rennie, CFP®, CFA®
President
Phone: (949) 650-8622
Fax: (949) 650-6683
Email: ecrennie@att.net

www.rennieandassociatesfp.com

Our Two 

It's tough to make predictions, especially about the future.
Yogi Berra (in memory)

Quarterly Trivia:

What do you call an unregistered, negotiable bond on which interest and principal are payable to the holder regardless of whom it was issued to?

This is called a bearer bond.