HIGH YIELD "JUNK" BONDS OCCUPY UNIQUE ROLE IN DIVERSIFIED INVESTMENT PORTFOLIO

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WHY CAN INVESTING IN HIGH YIELD "JUNK BONDS" BE APPEALING TO INVESTORS?

Historically, High Yield bonds (commonly referenced as "junk bonds") have added incremental return relative to Investment Grade bonds over longer periods of time. Their higher yield was enough to more than offset their increase in default risk. Today, fixed income investors confront a 0% cash/money market reality, and longer-dated investments in a basket of U.S. Treasuries and Investment Grade bonds yield less than 2%. The Bloomberg Aggregate Bond index, a very broad measure of most investment grade taxable bonds, currently yields a paltry 1.67% with an average maturity of 8.7 years. The higher yield of "junk" bonds are one avenue investors are exploring for additional income beyond traditional bonds and CDs.

HOW DO JUNK BONDS DIFFER FROM INVESTMENT GRADE BONDS?

The most obvious difference between Investment Grade and High Yield is, of course, the credit rating. Investment Grade bonds range from AAA to BBB and tend to rarely default. Anything below BBB though is considered "junk" and the likelihood of default increases as you move down the credit spectrum. Of course, along with the lower rating comes more yield and the hope for higher return. The average yield to maturity of the Bloomberg High Yield corporate bond index is currently 4.79% compared to 2.26% for Investment Grade corporate bonds. There are other differences such as average maturity and liquidity considerations, but higher yields and greater default risk are the high yield market's major defining factors.

WHAT ARE SOME OF THE RISKS OF INVESTING IN JUNK BONDS?

As you decrease credit quality, you typically increase the risk you might not get your initial principal investment back. Moody's Investors Service provides some context: The average annual default rate for Investment Grade corporate issuers over 20 years was 0.35% compared to the average annual default rate for High Yield at 1.96%.[1] Furthermore, when these bonds default they tend to have less recovery value than traditional higher quality corporate bonds. Aside from pure repayment risk, High Yield bonds tend to be less liquid than Investment Grade, which poses a risk should an investor need to sell a bond before maturity. They may also have materially higher swings in value (more volatility) over an economic cycle.

ARE JUNK BONDS A GOOD INVESTMENT CHOICE FOR THE AVERAGE INVESTOR?

Clearly it simply depends, and as with all investment decisions, investors should consult an advisor. Junk bonds historically have shown to be a bit more correlated with the stock market than with the bond market, so an Investment Grade buyer certainly picks up some diversification from the investment grade market while adding to their "equity like" risks. Secondly, High Yield bonds, much like stocks, tend to "win" when the economy is expanding, liquidity is good and overall credit is improving. They "lose" as we enter into periods of economic uncertainty or recessions. For long-term holders with a 10-plus year time horizon, junk bond returns have historically added a bit of value to compensate for their higher risks.

To put this question into context, where are we today? As our economy lifted off with the help of government stimulus and a receding pandemic, High Yield bonds have outperformed the investment grade market consistently since April 2020. But now yields are compressed, and High Yield bonds "only" out-yield their Investment Grade counterparts by much less than 3%, so there is less "yield cushion" for investment error unless our economic recovery continues for a number of years. Historically, the average U.S. economic expansion lasts about 7.5 years (since World War II), and we are only 1.5 years into this economic lift off. If we have a long enough "recovery runway" there will be time for the higher yields to accrue and offset what will become a growing default risk that occurs late in an economic cycle. These changed factors make it a much tougher call today than it was a year ago when junk bond yields were much higher.

Should an investor decide to add exposure to High Yield, one might consider highly diversified mutual funds or ETFs to help ensure that no one company represents an outsized risk to a portfolio. While mutual funds and ETFs have additional costs associated with investment, these costs have continued to decline over time and these alternatives provide additional oversight from fund managers with High Yield experience.

WHAT ROLE, IF ANY, SHOULD JUNK BONDS PLAY IN AN INVESTOR'S PORTFOLIO?

Each investor has a completely unique risk profile based on various characteristics such as age, lifestyle, dependents, etc. A financial advisor can better identify this profile and help an investor understand where he or she falls on the risk/return spectrum. With this in mind, High Yield bonds fill a gap that isn't addressed by a simple mix of Investment Grade bonds and stocks. With less risk than the equity market, yet higher yields than Investment Grade, High Yield not only occupies a unique position in terms of risk/return, but also helps investors diversify, which over time helps reduce volatility of returns – or more simply put – helps smooth out returns over time to help ensure that your principal is distributing investment risk efficiently.

[1] Moody's Investors Service - Annual Default Study – January 28, 2021; Exhibit 40 – page 46

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John is a portfolio manager for Commerce Trust Company. Upon gaining a thorough understanding of a client's needs and goals as well as assessing the client's entire financial situation, he works with our investment research team to construct a portfolio to help clients achieve their long-term goals. John comprehensively represents our research- and goals-based investment process, starting with the initial assessment and creation of an investment objective to ongoing evaluation and adjustments based on changing market and life circumstances. With a deep knowledge of the market and experience in investment management, he serves clients with thought leadership, insight, and consulting services. Prior to joining Commerce Bank in 2008, he worked as a financial analyst and a corporate credit analyst. John is a graduate of Marquette University and obtained his bachelor of science in business administration, majoring in both finance and marketing. John is a member of the board of directors of The Young Friends of St. Louis Children's Hospital and member of St. Louis University High School Alumni board.