

## INTRODUCTION

# LOWER GRADE BUT HIGHER YIELD

The hybrid asset class of high yield has seen significant product development

**H**igh yield bonds are corporate bonds that have quality ratings below investment grade (ie, Ba1, BB+, or lower). High yield bonds can be “fallen angels”, which are bonds of corporations that have been downgraded from investment grade (ie, Baa3, BBB– or higher). They can also be created by “original issuance”, new issues underwritten by investment banks.

Original issuance high yield bonds typically carry more protective covenants than investment grade bonds limiting the corporation from incurring additional debt or selling assets. Yields can be significantly higher for high yield bonds than investment grade bonds because of the higher business and financial risks inherent in high yield corporations. There are many different structures within high yield besides the traditional cash-pay coupon bonds, such as discounted, deferred interest bonds, pay-in-kind bonds, and even emerging market corporate debt.

**Example:** Lucent Technologies is one “fallen angel” that has dropped in quality ratings from A2 in December 2000 to its present rating of Caa1. Today, Lucent’s bonds maturing in year 2006 yield approximately 9.70 per cent.

## » GLOBAL MARKET

The current high yield bond market began in the 1980s. However, below investment grade bonds have been in existence for some time. When John Moody introduced Moody’s credit quality rating scale in 1909, it included ratings for below investment grade bonds.

But it wasn’t until the 1980s that mutual funds began to launch high yield bond funds specialising in these higher yielding, below investment grade bonds. Investment bankers began to capitalise on the demand for high yield bonds by underwriting original issue bonds. Because of the large number of high yield bonds issued to finance leveraged buyouts (LBOs) in the 1980s, the high yield market saw default rates climb to over 10 per cent in 1990.

During the 1990s, the market became much more liquid as nearly every large investment bank and commercial bank dedicated substantial resources to underwriting and trading high yield bonds. In the 1990s, as liquidity dramati-



**‘Given the globalisation of the market, high yield portfolio managers will be required to have a global vantage point’**

**Todd J. Youngberg, ABN AMRO**

ically improved, there were fewer LBOs. Protective covenants became standard and a broad market of institutional investors put their money to work in high yield bonds.

Today, there are nearly as many market makers in high yield bonds as there are in investment grade bonds, making high yield bonds much more tradable than in the 1980s. Today’s global high yield bond market is approximately \$875bn (€760bn) in size, with the European high yield market growing to an increasing share.

The high yield market is becoming more global with the advent of the European common currency, resulting in increased cross-border mergers and leveraged transactions. The euro has other implications for investors. With the end of currency strategies in Europe and a lower yield

environment, investors are adopting credit strategies to increase investment yields and returns. As a result, the European high yield market has begun to exhibit growth. The high yield market is expected to become more of a global universe as leveraged cross-border transactions increase and capital markets mature. Thus asset managers will be required to have a global vantage.

## » HYBRID CLASS

High yield bonds are a distinct, separate asset class. A separate asset class can be defined as one that has an expected return and volatility that cannot be replicated by a combination of other asset classes. A high yield bond is considered a hybrid: having characteristics of both fixed income (coupon payment) and equity (price appreciation).

The ABN AMRO Asset Management Global Consulting Group has produced an extensive research study titled "Credit Bonds as an Asset Class". In this study, the risk decomposition of the monthly total returns for both investment grade bonds and high yield bonds is evaluated. The study's results show that interest rates explain 90 per cent of the variation in investment grade bond returns, while equity markets explain 3 per cent, and only 7 per cent remains unexplained by these two factors.

However, with high yield bonds, the situation is very different. Interest rates account for only 3 per cent of the variation in high yield bond returns, while the equity market accounts for 24 per cent.

The remaining 73 per cent in return variability is unexplained by these two factors and is considered an intrinsic risk. This limited relationship with the bond and equity returns characterises the high yield asset class.

There are two critical characteristics of the high yield asset class that need to be considered:

- diversification benefits because of its low correlation;
- its strong risk-adjusted returns.

High yield bonds have a low correlation of returns to both the bond and equity markets, providing high yield investors with a unique tool for diversification (see Table 1). The low correlation to other asset classes provides a tremendous diversification opportunity. Adding high yield bonds into either a fixed income or equity portfolio is expected to improve the total portfolio's risk/return characteristics over a long-term horizon. High yield's diversification benefits are becoming an integral part in the global asset allocation decision.

Investment grade corporate bonds have a strong correlation (0.91) to the 10-year treasury and trade on a

### Correlation of monthly returns (1985 – Mar 31, 2003)

Asset class	High yield bonds
10-year treasuries	0.19
S&P 500	0.50
Russell 2000	0.56
Investment grade corporate bonds	0.46

Source: Merrill Lynch & Co.

spread-over-treasuries basis. With risk-free rates at relatively low yields currently, investors would be prudent to diversify away from investments whose returns are closely tied to treasuries. High yield bonds offer the opportunity to increase yield and reduce duration, or interest rate risk. (See Table 2.)

ABN AMRO's study analyses the effect on a diversified portfolio of bonds and equities when including investment grade bonds and high yield bonds separately. The results

### Yields and duration (Apr 30, 2003)

	Yield	Duration
ML Global High Yield Index	9.50%	4.1
ML Investment Grade Corporate Bond Index	4.50%	5.7

Source: Merrill Lynch & Co.

show that by adding investment grade bonds, the efficient frontier improves, thereby increasing the investor's return for each unit of risk. However, the expected return pick-up is more when high yield is added to the portfolio. For example, if the investor desires a risk tolerance of 9.37 per cent standard deviation (a benchmark), then an allocation to investment grade bonds adds 18 basis points of expected return, while a high yield bond allocation adds 21 basis points of expected return.

From a long-term perspective, high yield bonds offer investors one of the best risk-adjusted returns. A high

### Sharpe ratios (using monthly returns: 1985 – Mar 31, 2003)

Asset class	Sharpe ratio
High yield bonds	0.18
10-year treasuries	0.14
S&P 500	0.13
Russell 2000	0.06

Source: Merrill Lynch & Co.

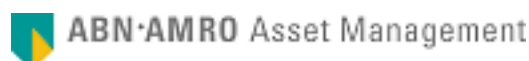
yield bond provides a rate of return to the investor through its high coupon payment and potential price appreciation if the credit quality improves.

The hefty coupon provides a cushion against volatility in the bond's price. High yield's return per unit of risk as measured by the Sharpe Ratio is superior to both treasuries and equity as illustrated in Table 3.

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## » CORPORATE STATEMENT

ABN AMRO Asset Management, which was established in 1933, currently manages more than \$170bn of clients' assets. We are one of the world's leading managers of high yield investments. Further details on our award winning mutual funds, which are available for distribution, can be found at [www.asset.abnamro.com](http://www.asset.abnamro.com).



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