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High-yield bonds raise yellow flags

They're more volatile than government or investment-grade corporate issues

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With long-term capital appreciation numbers in the red and stocks facing uncertain growth prospects, many advisors are exploring income-oriented options in the hope of bolstering future performance. With yields currently in the low teens, high-yield bonds that focus on "junk" or "below investment-grade" debt are garnering interest.

However, based on an analysis of U.S. high-yield bonds conducted by my firm, **Tacita Capital Inc.** of Toronto, caution is in order. High-yield bonds are called "junk" for a reason. Because of their higher default risk, high-yield bonds are much more volatile than government or investment-grade corporate bonds.

The annualized standard deviation of the Merrill Lynch U.S. high-yield master II index from January 1987 through April 2009 was 9.1%, significantly in excess of the 4.9% and 5.8% registered by the SBBI intermediate government bond index and the Merrill Lynch U.S. corporate master index, respectively.

To get a fuller picture of risk, it is important to look at drawdowns, the frequency and extent of declines from peaks to troughs. Since January 1987, the ML high-yield index has suffered eight drawdowns in excess of 5%, including a staggering loss of 33.3% from May 2007 to November 2008.

In contrast, the SBBI intermediate government bond index and the ML corporate bond index each experienced only one and three declines over 5%, with maximum losses of 6.9% and 16.1%, respectively.

Investors in high-yield issues were not adequately rewarded for this risk. The ML high-yield index had an annualized compound rate of return of 7.4%, only marginally ahead of the 7.0% return posted by both the intermediate government bond index and the ML corporate master index.

On the more important reward/variability metric, as measured by the Sharpe ratio, high-yield bonds ranked a distant last among bond categories.

High-yield bonds also had much higher correlation to equities than either government or investment-grade corporate bonds. The ML high-yield index had correlations of 0.56 and 0.48 with the S&P 500 composite and MSCI EAFE indices, respectively; a decided contrast

to the -0.03 and -0.08 correlations the intermediate government bond index had with the same respective indices. In essence, high-yield bonds, due to their default risk, combine equities-like and bond characteristics.

Because of this profile, in a series of mean-variance optimization runs, high-yield bonds earned only a marginal role in a diversified portfolio. Cash, government and investment-grade bonds dominated the conservative portfolios; equities dominated the growth-oriented portfolios. Hence, advisors should view high-yield bonds primarily as a cyclical trading opportunity with a minimal role in a long-term strategic asset mix.

Advisors will find that among high-yield mutual funds, there is a tremendous range in the level of exposure to below investment-grade bonds. This is because the fund industry's classifications require only that more than 25% of a fund's holdings be invested in high-yield securities or that the average debt rating be below investment-grade in order to be labelled as "high-yield."

For example, in the latest available disclosures, RBC Global Corp-orate Bond Fund, sponsored by Toronto-based **RBC Asset Management Inc.,** had 19.5% of its bonds rated below investment-grade, while Fidelity American High Yield Fund, sponsored by **Fidelity Investments Canada ULC**, had 93.2%.

Funds also vary materially in geographical focus and the degree of currency hedging. The result is a wide variation in return and risk profiles. Thus, careful selection becomes critical.

There are a handful of U.S. high-yield bond exchange-traded funds, with the largest being iShares iBoxx $ High Yield Corporate Bond Fund. But before buying any high-yield bond ETF, advisors must check the pricing relative to net asset value, as this is a less liquid asset class and premiums can skyrocket when investment demand surges. Currency risk is also an issue. **IE**

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