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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Roughly $1.7 trillion in worldwide debt now yields less than 0%

The USA's share of global defense spending has fallen from 47% in 2010 to 38% in 2014

Today's Junk Bond Market

The performance of junk bonds was mildly negative in 2014. This was a surprising result given the good returns logged by both investment grade bonds and US equities. Investors might reasonably ask about the risks in the junk or "high yield" bond space and what drives their performance. This edition of Intelligent Money will review the recent innovations in the junk bond market and offer some insights into how they might best be used as an investment tool.

Size and Composition of the Junk Bond Market

First, let's review some fundamentals. A junk bond is a debt security that carries a credit rating below BBB- by Standard & Poor's and Baa3 at Moody's Investors Service. As such, junk bonds are viewed as having higher likelihood of default. Historically, America's high yield bond market consisted almost exclusively of companies that originally issued as investment grade debt but had fallen upon hard times. Bonds like these were known as "fallen angels". In the late 1970s, American investment banking firms, led by the controversial Drexel Burnham, & Lambert, began underwriting debt that debuted as junk credit. The high yield space has since made great strides. The estimated size of the domestic high yield market is $1.3 trillion. That's about one third the size of the entire US corporate bond market.

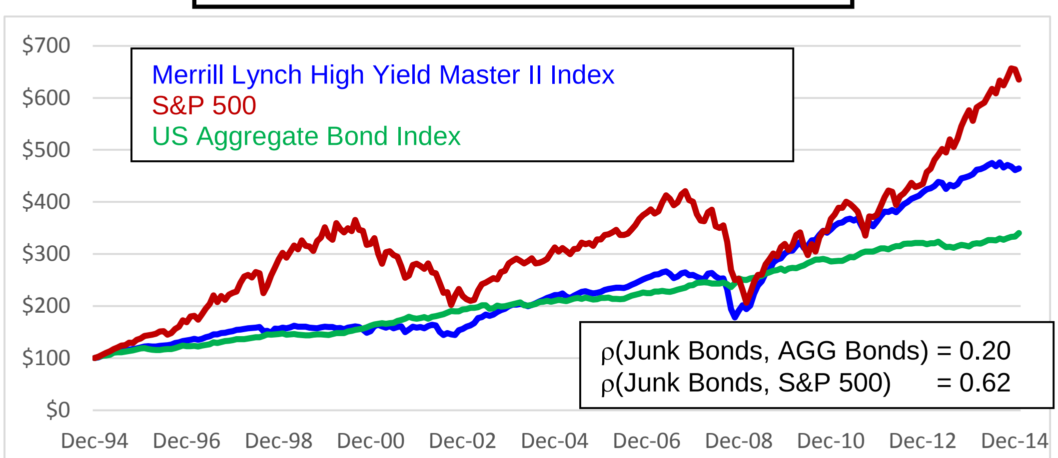
As the junk bond market has grown, benchmarks designed to measure its performance have been developed. The one most commonly recognized is the Merrill Lynch US High Yield Master II index. It consists of over 2000 domestic issues that include interest bearing, pay-in-kind, and zero coupon bonds.

There are numerous investment products that specifically address the high yield market and allow investors to take a position in a diversified portfolio of high yield bonds at low cost. For example, there are about 225 mutual funds and 40 exchange-traded funds (ETFs) that primarily invest in junk bonds. The latter category is growing more rapidly as assets under management increased more than tenfold since 2008.

Junk Bond Performance.

The world's central banks have systematically repressed interest rates since the 2008 recession. High quality corporate bonds offer little in the way of return. beyond inflation. Government credits barely offer a positive return at all. Lots of investors have started looking closely at high yield bonds. Money has poured into junk bond funds in the last several years. And most of these funds have delivered good performance. The chart below illustrates the broad strokes of junk bond price movement.

Growth of $100 invested twenty years ago



Junk bonds are a relatively new asset class, with comprehensive performance benchmarks dating back only to the 1980s. Total returns on junk bonds have been excellent. Moreover, their correlation with other major asset classes is low. We've summarized some key performance measures over the last twenty years. The table below compares high yield bond performance with popular US and Bond benchmarks.

Data from 1995-2015

	Junk Bonds	US Bonds	S&P 500
Annual Return	**7.9%**	6.2%	9.5%
Annual Volatility	**8.9%**	3.6%	15,2%

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Like the stock market, high yield bonds have valuation metrics often cited by pundits as evidence of buy or sell signals. The stock market has its price/earnings ratio. The junk bond market has a "spread to treasury" measure. This is basically the difference between the yield on a junk bond less the yield of a treasury bond of comparable maturity. Neither the price/earnings ratio nor the spread to treasury has demonstrated any tendency to foretell future price movements. That said, it is instructive to review the recent history of the spread to treasury measure.

The recent recession witnessed a dramatic selloff in junk bond prices. At the same time, the Federal Reserve undertook a massive buying program for short term treasury bonds. Junk bond and treasury prices moved in opposite directions, sending yield spreads through the ceiling.

At the height of the recession. Junk bond yields were more than 20% higher than treasuries. The implied default rates on high yield debt reached extraordinary levels – which were never actually attained. In fact, the annual default rate on junk bonds is near an all time low. Defaults comprised a little more 2% of outstanding junk debt in 2014. The historical average is closer to 4.5%.

As the chart at the bottom of the page illustrates, yield spreads today are similar to what prevailed in the early part of the century. Moreover, the default environment is relatively benign. With the benefit of hindsight, one might reasonably conclude that junk bonds were undervalued during the recession. However, no such bright line measure argues one way or another today.

Recent Pricing Action with Junk Bonds

Industry risk factors are often overlooked when junk bonds are evaluated. Investors typically focus on the larger economy when evaluating the suitability of a junk bond investment. They often perform poorly during recessions. However, recent trends in the composition of the junk bond market have confounded conventional wisdom.

The shale revolution in the United States created a thirst for investment capital in the energy sector. Many oil service and exploration companies financed unconventional drilling operations with high yield debt. Energy issues now comprise 17%

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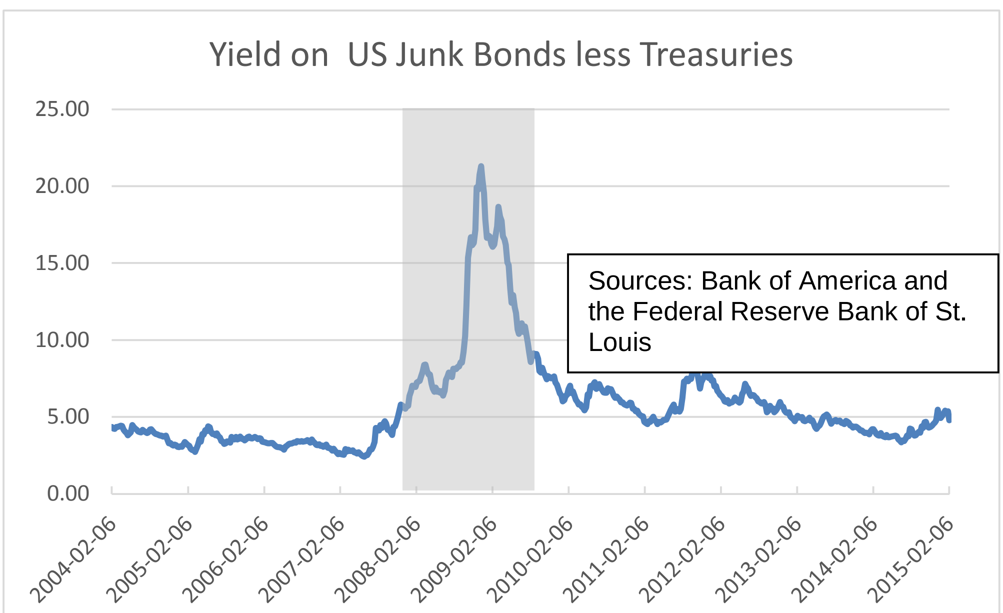

"Energy issues now comprise 17% of the US junk bond market, up from only 10% just before the recession."

of the US junk bond market, up from only 10% just before the recession. It's now the largest industry concentration. In fact, energy is about twice as concentrated in the junk bond market as it is in the US stock market.

During the first half of 2014, junk bonds kept pace with higher grade credits and a rising stock market. However, OPEC's refusal to cut oil production in November in response to an emerging oil glut decimated the price of hydrocarbons. America's shale oil companies are high cost producers. Their cash flow suffered as the price of their key product was cut in half in the second half of the year.

Default worries took hold on the highly leveraged energy sector and the debt prices fell 10% of more. Thus, the woes of the America's shale oil producers dragged down the overall junk bond market.

With the new year, macroeconomic factors have weighed in to help the junk bonds market. The price of oil has stabilized and the European Central Bank (ECB) has embarked on a highly accommodative monetary policy. Yields on junk debt worldwide have declined substantially since the ECB announced a trillion dollar bond-purchase program on Jan. 22.

Liquidity Issues with Junk Bonds

Individual high yield bonds suffer the same pricing drawbacks of other corporate bonds. They are not nearly as liquid as individual stocks. That can have serious consequences for retail investors, particularly those that try to sell junk bonds before maturity.

Bid/ask spreads for small lots of junk bonds typically exceed 1%. Prior to the financial crisis, Wall Street dealers made markets in high yield debt. They would retain large inventories of product and transact from these inventories to earn a profit spread. Financial reforms (more stringent capital requirements) since the recession have made risky assets less desirable for banks to hold. Indeed, the amount of corporate debt and commercial paper in dealer portfolios has fallen 80% since 2008.

Ordinarily, the reduction in inventory should herald higher trading costs for investors. Instead a new model of transacting has evolved. Dealers are more often than not putting willing buyers and sellers together as they eschew the risk of market loss. Dealers are only acting as middlemen for about 60 percent of high-yield bond transactions bigger than $2 million, moving securities between two sides they already have lined up, according to data compiled by financial-research company Tabb Group LLC. Before the 2008 financial crisis, such trades accounted for an estimated 25 percent of their business.

Electronic means of bond price discovery have expanded dramatically. One fundamental example is the TRACE system, introduced by the NASD in 2002 and gradually enhanced since then. For example, real time reporting became a requirement in 2006. It has become a comprehensive database of bond transaction data. Bottom line is that retail investors can get a pretty good idea of where a bond *should* trade based on very recent *publically available* transaction data.

Access to information has, on balance, swamped the effect of reduced dealer inventory. This has driven down overall trading costs in the junk bond space. Electronic trading platform, Marketaxess, has compiled a trade-weighted index of bid/ask spreads in the junk bond space since TRACE started reporting comprehensively. The results indicate a clear trend to narrower spreads.

Conclusion

Trading costs aside, most investors lack the resources to diversify a junk bond portfolio. It's too expensive. Retail investors should NOT build portfolios of individual bonds. Delegate the task to the professionals – those that aggregate investment capital. Of course, some investors may find themselves with individual bonds through gift or inheritance. Tools now exist online to insure that they get a reasonable price.

The attractive historical performance of junk bonds is not an argument to use them as a primary holding in a fixed income portfolio. The overall size of the junk market pales in comparison to sovereign and agency issues outstanding. That's where diversified portfolios must retain focus. High yield bonds can augment returns with a reasonable increment to risk if they are used intelligently in a satellite role.

Controlling costs is an important element in the use of any asset class. Investors should employ tools that invest primarily or exclusively in that asset class. Some low cost funds that participate in the junk bond space include Vanguard's High Yield Corporate Fund (VWEAX), Ishares High Yield Corporate Bond ETF, and the Spyder Short Term High Yield Bond ETF (SJNK). As you can see, nobody likes the term "junk" in the title of their fund.