

A High Income Opportunity in a Low Yield World

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High Yield Bond Basics

What is a high yield bond?

High yield bonds are corporate bonds rated below BBB- or Baa3 by established credit rating agencies. High yield bonds typically offer higher interest rates or coupons than government bonds or high grade corporate bonds. They also have the potential for greater capital or price appreciation in the event of a ratings upgrade, an economic upturn or improved performance at the issuing company. High Yield bonds are generally less sensitive to interest rate risk and, over the long run, tend to offer equity-like returns with less volatility.

Who issues high yield bonds?

The high yield market was created in the 1980s, when companies with below-investment grade ratings sold corporate bonds in order to finance mergers and acquisitions or leveraged buyouts. The high yield market has since evolved, and today, much high yield debt is used for general corporate purposes, such as financing capital needs or consolidating and paying down bank lines of credit. Mainly focused in the U.S. through the 1980s and 1990s, the high yield sector has since grown significantly around the globe in terms of issuance, outstanding securities and investor interest. High yield bond issuance has grown significantly in Canada in recent years. New high yield issuance can vary greatly from year to year depending on economic and market conditions, typically expanding along with economic growth, when investors' appetite for risk often increases, and waning in recessions or market environments when investors are more cautious.

Why invest in high yield bonds?

High yield bonds offer investors a number of potential benefits, including:

- **Enhanced current income:** High yield bonds have higher coupons and yields than government and investment grade corporate bonds. Historically, high yield bonds have offered 300 to 400 basis points of additional yield relative to government bonds. Today, that spread is over 600 basis points.
- **Capital appreciation:** With better macroeconomic conditions and/or improved performance by issuing companies, high yield bond prices can move higher. This capital appreciation is an important part of the total return potential and investment approach in high yield bonds.
- **Equity-like long-term return potential:** High yield bonds and equities prices tend to move in a similar way to the overall market environment, which can result in similar returns over a market cycle. However, the returns on high yield bonds tend to be less volatile because the income component of the return is typically larger than that of equities, adding stability. High yield bondholders also have priority over stockholders, as bonds are higher up in the capital structure. The result is that high yield bonds can offer equity-like total returns for less risk than equities.
- **Relatively low duration:** High yield bonds are generally less sensitive to changes in interest rates, which tends to lower volatility. High yield bonds have a lower sensitivity to interest rates because: (1) they tend to have shorter maturities (maturities of 10 years or less) than other fixed income investment options; and (2) with their higher spreads over government bonds, they have more room to absorb changes in interest rates. In a rising rate environment, high yield bonds would be expected to outperform many other fixed income investment types.

Conclusion

High yield bonds can play an important role in an investment strategy by enhancing return potential while improving diversification, particularly given their low correlation with interest rates. High yield bonds and equities share similarities, but the income provided by high yield bonds and their senior placement in the capital structure help make these securities less risky than stocks. High yield bond investments fit into the space between equity and fixed income.