High-yield bonds—What you need to know

High-yield bonds, also referred to as “junk bonds,” are debt securities issued by companies deemed too risky to be assigned an investment grade credit rating by any of the major rating agencies: Standard & Poor’s (S&P), Moody’s and Fitch. The rationale for non-investment grade ratings includes an elevated use of leverage, high business risk and low earnings relative to interest payments. As a result, investors should view the higher yields available on high-yield bonds as compensation for the higher level of credit risk these securities possess. But, just because a bond is rated high-yield by a credit rating agency doesn’t necessarily mean the issuer will default. For example, some issuers view higher levels of leverage as an optimal capital structure. This leverage could be used to invest in the business, finance acquisitions or return capital to equity shareholders. We believe there may be a place for high-yield bonds in certain clients’ portfolios, despite the higher credit risk. They can provide the benefits of portfolio diversification, higher income to investors and the potential for price appreciation, in many cases, all while maintaining a senior position to common stock on a company’s balance sheet.

Key risks

High-yield bonds are rated below BBB- or Baa3 (see Chart 1). As you progress down the rating scale, liquidity can decrease while default risk, price volatility and yield typically increase.

Rationale for high yield ratings

- **Higher leverage**—Leverage measures how much debt capital a company has on its balance sheet relative to its equity capital. High-yield issuers typically have more leverage than investment grade companies. Greater leverage increases an issuer’s financial risk as servicing debt payments could become more difficult if economic/business conditions deteriorate and cash flow generation falls.

- **Interest coverage**—Interest coverage is expressed as a ratio that measures the income or cash flow a company generates to its interest payments. Because high-yield issuers carry more debt, they must also make higher annual interest payments to their lenders (investors). High-yield issuers usually have lower interest coverage ratios, meaning they generate less earnings relative to their required interest payments—increasing the possibility of an interest payment default should business conditions suffer.

- **Business risk**—In general, the business in which a company operates can influence its credit worthiness based on the predictability of revenues. Typically, high-yield issuers operate in industries where cash flows may be highly cyclical, are subject to fluctuations in commodity prices, or operate in industries with intense pricing pressures. For example, energy companies comprise a significant portion of HY indices, and due to their reliance on oil prices, they can experience margin pressures when oil prices fall, raising the difficulty of making interest payments.

When an issuer fails to make an interest or principal payment it is referred to as a default. During times of economic distress, high-yield issuers typically default at much higher rates than investment grade issuers. According to Moody’s, during the peak of the most recent recession (2009), high-yield bonds defaulted at a rate of 12.1 percent, which compares to the long-term investment grade default rate of 0.43 percent. Current default rates for high yield bonds remain between 3 percent and 4 percent—with an average default rate of 2.70 percent since 1950 (see Chart 2).

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Benefits

- **Diversification**—For the appropriate risk-oriented investor, high yield can provide diversification benefits to their fixed income portfolios. Investing in high-yield bonds may offer exposure to different industries that might otherwise be unavailable through traditional asset classes. In some cases, companies may not have publicly traded equity, but investors can gain exposure to these businesses through publicly traded high-yield debt.

- **Higher income (Chart 3)**—High-yield issuers must offer higher interest rates relative to investment grade bonds in order to compensate investors for taking increased risk. On average, high-yield bonds have offered a yield advantage of 4 percent over investment grade bonds since 1987. High-yield bonds typically offer higher coupon rates than investment grade bonds, which can benefit investors by reducing price sensitivity to changes in interest rates.

- **Price appreciation**—With a risk/return profile more similar to equities, high-yield bonds often have a greater potential for price appreciation than investment grade bonds. High-yield bonds can experience an increased market price for a variety of reasons, including stronger economic growth and improved business fundamentals that could lead to credit ratings upgrades.

- **Capital structure seniority**—Although high-yield bonds have historically been correlated to equities, high-yield bondholders remain senior to equity holders in the event of bankruptcy or liquidation—regardless of issuer credit quality. A basic capital structure goes in order: senior debt, subordinated debt, preferred stock, and common stock. High-yield bonds will fall into either the senior or subordinated debt portion of the capital structure. This means that in the event of a bankruptcy or liquidation, high-yield bond holders will be paid before preferred and common stock holders.

**Where do high-yield bonds fit in your portfolio?**

The growth of high-yield bonds as a more widely available asset class began in the early 1980s. Fixed-income investors have continued to increase allocations to high-yield bonds as rates have moved progressively lower over the last 30+ years, and high-yield bonds now represent an estimated 15 percent of the corporate bond market according to the Securities Industry and Financial Markets Association (SIFMA). Even though this asset class can offer many benefits, it is important for investors to note that high-yield bonds have different risk and return profiles than other asset classes, and they must consider their own risk tolerance prior to investing. RBC Wealth Management has established a High-Yield Policy for its financial advisors to address levels of risk for clients. Please consult your financial advisor to see if high-yield bonds are an appropriate investment for you.