Clark Capital Management Group

NavigatorInsights

High Yields: Love 'em if You Can Leave 'em

Investor demand for high yield debt has been strong in recent months. And even though spreads have come down and the opportunity for capital appreciation is lower, there simply aren't many other options for investors looking for yield.

Treasuries, understood to be the safest sector in fixed income, are currently kicking off too low of a yield to satisfy investors' appetite for income. However, fixed income is an important part of an investor's diversification strategy. Along with providing income, we believe it has an important place in an asset allocation strategy. And because investors would need to take on excess duration risk in order to increase yield in treasuries, (more on understanding duration here) many are choosing to take on credit risk instead. In our opinion, this is a more prudent decision — provided the investor is using an active approach to managing the fixed income piece of their portfolio.

But What About Energy Risk in High Yields?

Lately one of the most disruptive players in the high yield space, energy, has been somewhat suppressed in its ability to disrupt high yields. High yield bonds with energy exposure have not been as affected by struggling oil price as they were earlier this year and last year. We attribute this to two likely factors: a spring cleaning of sorts in the energy space, and stronger stomachs among investors.

According to a recent Barron's article[1], nearly a quarter of the high yield energy universe has defaulted, leaving traditionally higher credits in the energy space in the "junk" arena. In addition, having lost out on a moderate recovery by remaining out of high yields following last December, investors may be more likely to stick with energy exposure through its ups and downs. This past spring, investors who capitalized on the rally in energy and the overall high yield markets enjoyed large gains, as high yield spreads came down versus Treasuries.

Embrace High Yields with a Flexible Approach

We are currently invested in SJNK, HYG, JNK to give investors broad based exposure to the high yield space. We believe the best way to potentially capitalize on opportunities in higher risk areas of fixed income is to take an active approach and utilize a broad set of tools to manage changing interest rates and volatility in bonds. Although things look good now, conditions in high yields can deteriorate rapidly. That's why we do not advocate a simple buy-and-hold approach to high yield debt. It's important to be able to move to safer areas of fixed income when necessary.

Yield curves flatten, rise, fall and twist, and all of these scenarios create opportunities to deliver value above and beyond just the coupon. There are several ways to deliver greater return to the client by being active along the yield curve and maturity spectrum. By being passive, you forego that opportunity.

Using actively managed, nontraditional bond strategies may help provide better risk-adjusted returns in a rising rate environment. Since the nontraditional bond category is a relatively new Morningstar category, it's important to do your research before selecting a strategy. Nontraditional bond approaches should have well defined objectives and levels of risk that the portfolio manager will take. Being flexible within one's fixed income allocation is important. For instance, a tactical fixed income manager will compare the benefits of taking duration versus credit risk. It's important for that manager to understand where we are in the business cycle. In our view in good phases of the cycle, it pays to be aggressive; in bad, it pays to be defensive. We believe a flexible approach can add a lot of value in the fixed income space.

High yield bonds have a fraction of the liquidity provided by stocks or Treasuries. For these reasons, we believe gaining exposure to this asset class is best achieved through the use of ETFs. A list of the largest high yield bond ETFs follows:

Ticker	Fund Name	Issuer	Expense Ratio	AUM	Segment
HYG	iShares iBoxx High Yield Corporate Bond ETF	BlackRock	0.50%	$13.96Bil	Fixed Income U.S. Corporate High Yield
JNK	SPDR Barclays High Yield Bond	SSgA	0.40%	$12.05Bil	Fixed Income U.S. Corporate High Yield

Source: ETF.com

For more on high yields' unique ability to generate income and protect principle if rates begin to rise, read Curing Two Ills with High Yield Bonds.

1. As Oil Drops, Energy Junk Bond Holders Stay Calm,
http://www.barrons.com/articles/as-oil-drops-energy-junk-bond-holders-stay-calm-1470457520

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