



# “Fallen Angels” Gain a Rising Profile in High Yield

Bonds downgraded from investment grade to speculative grade historically have outperformed other areas of high yield—but we believe a selective approach to these securities is crucial.



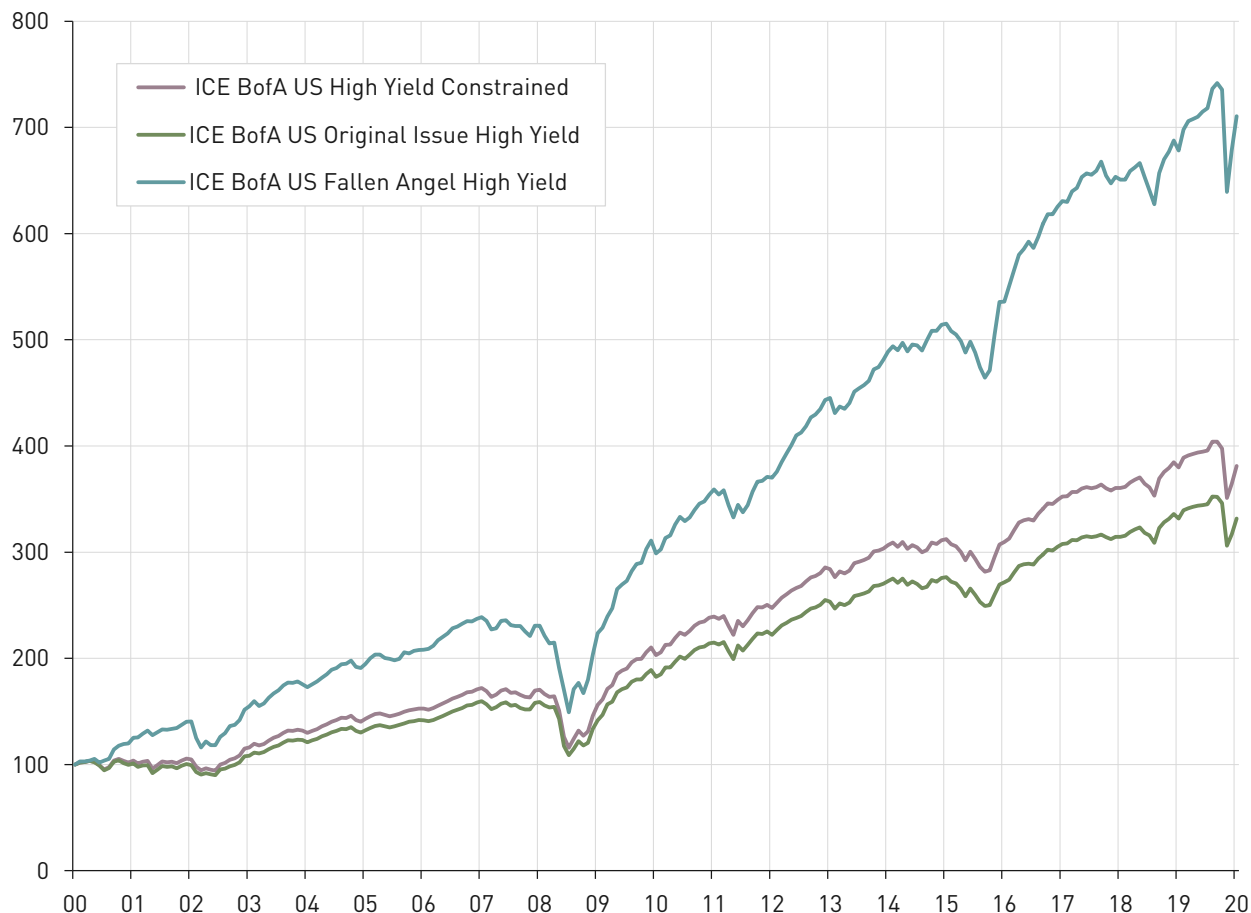
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**Figure 1. Fallen Angels Historically Have Outperformed Other Segments of U.S. High Yield**

Returns for the indicated indexes, May 31, 2000–May 29, 2020



Source: FactSet. Data as of May 29, 2020. Starting value of 100 as of May 31, 2000.

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At the worst point of [the recent selloff in U.S. high yield bonds](#), the spread on the ICE BofA U.S. High Yield Constrained Index widened to 1,087 basis points (bps) on March 23, the highest level in 11 years. Spreads have since recovered to 661 bps as of May 28. The pandemic-fueled economic crisis, concurrent with oil price volatility, led to a steep increase in the number of fallen angels—bonds that have seen their ratings move below investment grade due to a deterioration in the financial condition of the issuer. Year to date through May 15, some \$171.4 billion of debt by dollar volume has been downgraded from investment grade to high yield.

But some of the fallen angels appear to have caught a break on April 9, courtesy of the U.S. Federal Reserve (Fed). Among the policy moves announced by the Fed on that date was \$2.3 trillion of support for credit markets through the expansion of the Primary Market Corporate Credit Facility (PMCCF), the Secondary Market Corporate Credit Facility (SMCCF), and the Term Asset-Backed Securities Loan Facility (TALF).

These actions helped boost investor confidence, in our opinion, most notably as the Fed included the purchases of select fallen angels in the programs. In order to be eligible for purchase, issuers must have had an investment grade rating on March 22 and have since been downgraded to one of the top three tiers of the high yield ratings spectrum (BB+, BB, or BB-). Since the Fed's announcement on April 9, spreads on many fallen angels bonds have rallied, based on Bloomberg data, leading to what we consider attractive returns.

### Credit Downgrades Can Create Market Inefficiencies

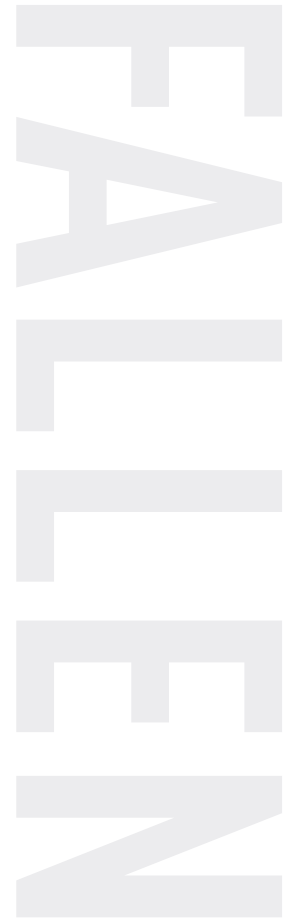
We generally view fallen angels as a potential source of alpha generation. Downgrade actions may create market inefficiencies, due largely to the size difference between the benchmark investment grade and high yield indexes<sup>1</sup> and forced selling of the recently downgraded issues by investment grade investors. Together, these dynamics may lead to oversold valuations for fallen angels. The face value of the ICE BofA U.S. Corporate BBB Index increased by over 50% over the five years ended May 29, 2020.<sup>2</sup> In fact, the 'BBB' credit tier now accounts for nearly half of the U.S. investment grade market and is almost three times the size of the U.S. high yield market.<sup>3</sup> Due to the size differential, price moves can be exacerbated as supply within the investment grade market surpasses demand within the high yield market.

Typically, prior to and following the downgrade of a fallen angel, spreads widen. However, historically spreads have tended to rally once the company begins trading within the high yield universe.<sup>4</sup> For example, Apache, an oil and gas exploration and production (E&P) company, was downgraded by Standard & Poor's on March 26 from BBB- to BB+, which brought the company's rating to speculative grade.<sup>5</sup> (See Figure 2 on next page.) Beginning roughly 10 days prior, the prices on Apache bonds fell to roughly \$50 at their worst, but have since rebounded and as of May 28, were trading in the low \$90s.

It is worth noting, though, that not all fallen angels will exhibit substantial spread tightening. Occidental Petroleum, another E&P company, was downgraded by Moody's on March 18 from Baa3 (investment grade) to Ba1 (speculative grade). As Figure 2 shows, prices of Occidental's bonds fell to roughly \$50 as well; however, the subsequent price rally was more modest, to the mid \$70s as of May 28. While fallen angel performance has been shown to be largely positive in these instances, there are some idiosyncratic factors that must be considered.

### Fallen Angels Historically Have Delivered Attractive Returns Relative to New Issues

From a long term perspective, the broad fallen angel cohort has delivered attractive absolute returns relative to both original issuers within the high yield index and the ICE BofA U.S. High Yield Index, in our view. The returns also look compelling on a risk-adjusted basis. As of April 30, the 10-year Sharpe ratio on the ICE BofA U.S. Fallen Angel High Yield Index was 0.96, versus 0.69 for the ICE BofAML US Original Issue High Yield Index and 0.73 for the ICE BofA US High Yield Index.

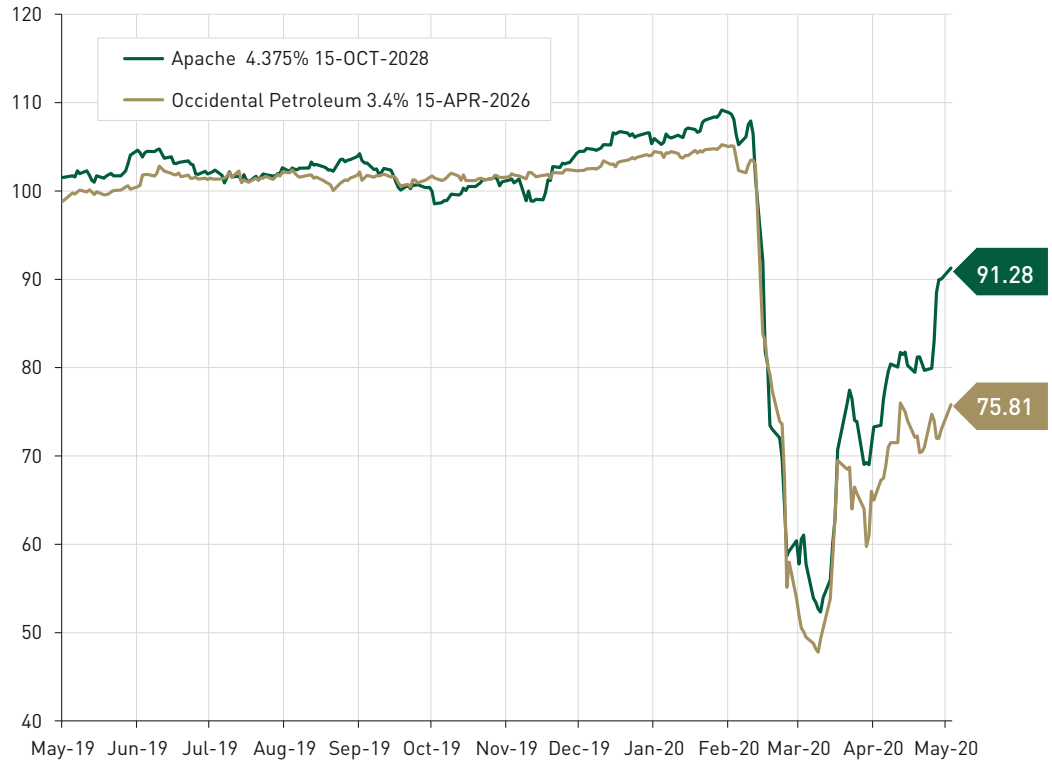




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### Figure 2. A Tale of Two Fallen Angels from the Oil Patch

Prices for indicated bonds, May 24, 2019–May 26, 2020



Source: FactSet. Data and closing values as of May 26, 2020.

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Fallen angels’ historic positive performance (see Figure 1 on the front page) can be attributed to a number of factors, in our view. As previously discussed, these bonds generally enter the speculative grade market at oversold prices due to technical selling pressure. Further, relative to other speculative grade peers, a company recently cut to below investment grade may have a more advantageous debt structure with longer dated debt and lower coupons, which effectively reduces the cost of capital. Fallen angels are also among the highest quality issuers within the high yield market, and are generally larger-capitalization companies with more liquidity and resources—including dividend flexibility and the ability to sell assets—to address potential financial concerns. Together, these attributes may attract buyers within the high yield index.

#### A Final Word on Fallen Angels

While fallen angels may present opportunities for outperformance, there is still risk involved. Moody’s found that for the two years following the downgrade into the high yield universe, fallen angels exhibited a higher default risk than a control group of similarly rated speculative grade issuers that were original issues within the high yield universe. Therefore, while fallen angels may offer an attractive opportunity, we believe it is advantageous to employ a skilled manager with the credit research and security valuation capabilities needed to navigate the crossover between investment grade and speculative grade.



<sup>1</sup>The ICE BofAML U.S. Corporate Bond Index and the ICE BofA U.S. High Yield Index, respectively.

<sup>2</sup>Source: FactSet.

<sup>3</sup>Source: ICE Data Indices.

<sup>4</sup>Source: CreditSights.

<sup>5</sup>References to individual companies are for descriptive purposes only and do not reflect opinions on their investment merits.

**A Note about Risk:** The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

**Treasuries** are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **basis point** (bp) is one one-hundredth of a percentage point.

For bonds, **face value** is the amount paid to the holder at maturity, which is customarily \$1,000. The face value for bonds is often referred to as "par value" or simply "par."

**Fallen angels** refers to bonds that have been downgraded from investment grade to speculative grade status.

The **Sharpe ratio** measures the performance of an investment (e.g., a security or portfolio) compared to a risk-free asset, after adjusting for its risk.

**Spread** is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one one-hundredth of a percentage point).

The **ICE BofAML U.S. High Yield Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The ICE BofA U.S. Fallen Angel High Yield Index (bonds downgraded from investment grade to speculative grade) and the ICE BofAML U.S. Original Issue High Yield Index (bonds originally issued with below investment grade ratings) are subsets of the ICE BofA U.S. High Yield Index.

The **ICE BofAML U.S. High Yield Constrained Index** is a rules-based index consisting of U.S. dollar-denominated, high yield corporate bonds for sale in the U.S. The index is designed to provide a broad representation of the U.S. dollar-denominated high yield corporate bond market. The index is a modified market value-weighted index with a cap on each issuer of 2%. returns also look compelling on a risk-adjusted basis.

The **ICE BofAML U.S. Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$250 million.

ICE BofAML Index Information:

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The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

The credit quality of the securities are assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from "AAA" (highest) to "D" (lowest). Bonds rated "BBB" or above are considered investment grade. Credit ratings "BB" and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principle on these securities.

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