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Three Reasons to Consider High Yield in Today's Market

Even after a rally in U.S. high yield in 2019, we believe the case for an investment allocation to the asset class remains alive and well.

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IN BRIEF

- **Our analysis of historical data shows that investors in U.S. high yield have experienced positive returns even when default rates are modestly elevated. .**
- **Holding periods of three years or more have led to nearly uniformly positive absolute returns in high yield over our study period. We believe this resiliency argues for a *strategic* allocation to this asset class rather than a *tactical* one.**
- **Finally, an analysis of the cumulative total return since 2008 shows that income has provided multiples of price return in U.S. high yield, even in a period that starts with deeply discounted prices. Time in the markets matters more than an investor's entry point.**

By and large, 2019 was a great year to be invested in U.S. high yield credit, although some tactically oriented investors may not have fully participated in the rally given the steep decline into 2018's year-end and the "V" shape return profile of January 2019. Many of the traditional "late-cycle" arguments for avoiding the asset class persist today, and spreads are clearly at a less attractive entry point in early 2020 than they were at the end of 2018. However, statistically speaking, we believe regret over missing out on the advance is not a strong argument to avoid the asset class as it has historically proven to reward investors who have embraced it as a strategic allocation in their portfolios.

Here, we examine how certain potential objections to adding to the asset class, namely late -cycle concerns over projected default rates and today's tighter entry credit spreads, should not dissuade investors with a suitable risk appetite and an appropriate holding period. Further, we explore the importance of the high income aspect of the asset class as the key driver for returns.

1. U.S. High Yield Has Fared Well Even When Default Rates Have Risen Modestly

One recurring argument against entering the high yield market that we've encountered is the prospect that the corporate default rate is set to continue a slow climb into 2020. But what is the historic relationship between the default rate and ensuing return in high yield? To start, in Chart 1 we show Moody's "Base"- and "Optimistic"-case projections of the U.S. speculative grade default rate through December 2020. It's notable that even under the base-case scenario, the rating agency sees the corporate default rate ending the year slightly lower than the most recent reading at the end of 2019. Meanwhile, the optimistic case sees the projected LTM (last 12 months) default rate at year-end 2020 approaching the 2013–2014 lows reached before energy sector weakness spurred a modest rise in defaults that peaked in 2016.

Chart 2 takes things a step further. Using data from 1999 to the present, the left panel is a scatterplot of the 12-month forward actual default rate experience versus the realized total return of the U.S. high yield market over the corresponding 12-month periods that followed. The line chart on the right reflects the same data as on the left but just constrained on the y-axis to show when high yield total returns turned negative on a 12-month forward basis.

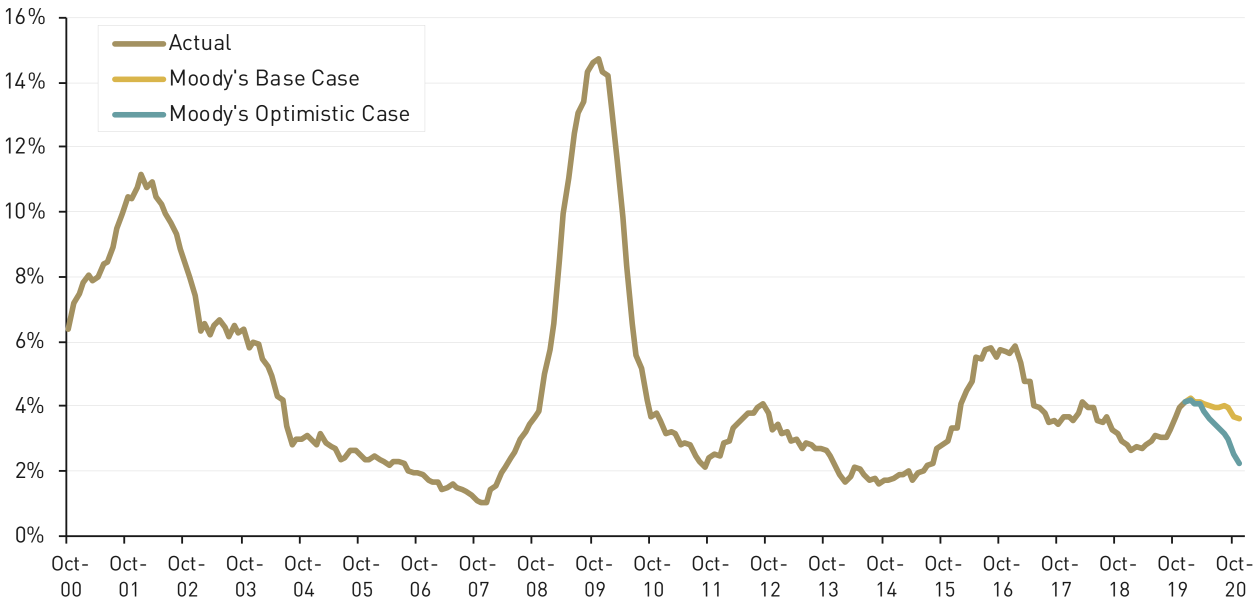
So what do high yield total returns look like when the 12-month forward default rate matches the above default scenarios for 2020 from Moody's? We can narrow down the data from the scatter plot.

a. **Historical guidance for the "Baseline/Optimistic" default scenarios**: Specifically, we first look to when the 12-month forward default rate ranged between 3.5%–5.0% (i.e., in-line with Moody's Baseline and Optimistic views shown earlier). We have 39 observations here and we find that the median 12-month forward high yield total return was 8.6%, with just six observations of negative returns over the following 12 months (three observations in the 12-month periods starting in late 2007/early 2008, and the three in the forward periods starting in March, April and May of 2015). It is important to note that the median starting yield-to-worst (YTW) for these periods was 7.22% (versus 5.49% today).

b. **Historical guidance for a "Pessimistic" scenario**: Here, we restrict the data to observations of a forward default range of 5.0%–7.25% (at worst, approximately half of the 2008 peak as we have great difficulty envisioning a repeat economic outcome in this cycle playing out over the next 12 months). We have 32 observations here, and we find the median 12-month forward total return for high yield was actually 14.9%, with just five observations of negative returns over 12 months. Most of these periods were during the credit market recovery of 2002, as well as the 12-month returns that followed from late 2015/early 2016 (when the default rate approached 6%). Essentially, if you believe

Chart 1. Moody's Sees the Base-Case U.S. Default Rate as Reasonably Stable through 2020

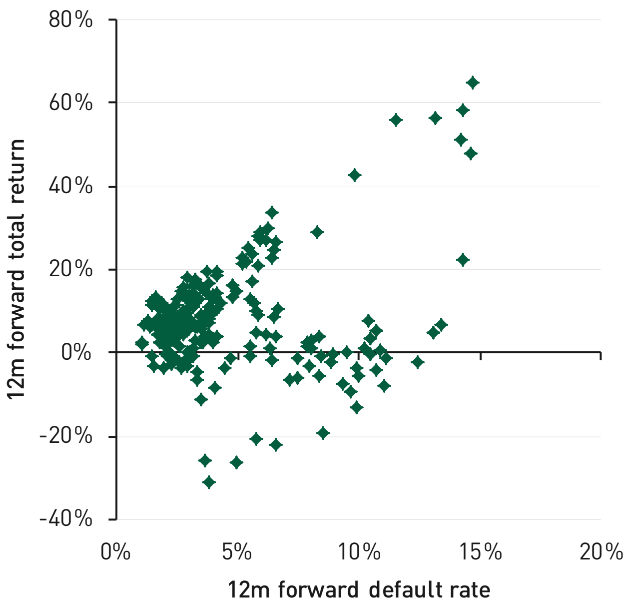
As-reported default rates on U.S. high yield bonds for October 31, 2000–December 31, 2019 and projected rates for 2020

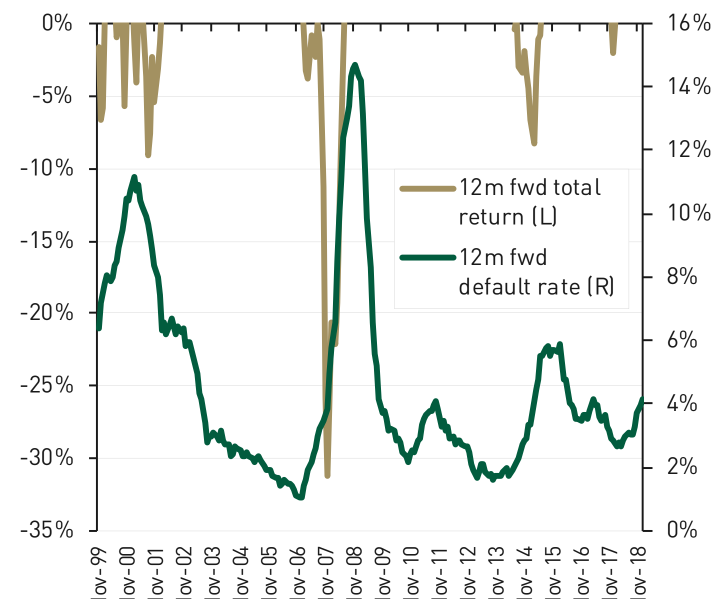


Source: Moody's Investor Service, Lord Abbett & Co LLC. Data as of December 31, 2019. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results.

Past performance is not a reliable indicator or guarantee of future results.

Chart 2. Negative Returns are Reasonably Rare in High Yield When Default Rates Are at or Below 5%





Source: Moody's Investor Service, Bloomberg Barclays Indices, Lord Abbett & Co LLC. Data as of December 31, 2019. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results.

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the default rate will go into this range over the coming 12 months, history suggests buying high yield. This indeed sounds very counterintuitive on the surface, but the missing logic link is that much credit distress was already 'in the price' at these points in time, with the median starting YTW for these periods at 11.4%. That's a far cry from today's level of 5.49% that suggests a much more benign forward environment.

What are the main takeaways? History has shown that it's rare to experience negative returns in high yield even if the default rate is going to rise from here by a modest amount. Also, just by eyeing the scatterplot above, it appears that high yield total returns are a bit more clustered around 0% when the default rate is at 7.5% or above – reasonably higher than the default rate environment projected by Moody's as a base case for 2020.

2. Investors May Still Have an Attractive Entry Point, Even With Tighter Credit Spreads

In addition to default concerns, the other understandable caution some investors share in allocating to high yield today is simply that spreads already tightened sharply in 2019. We won't examine the broader topic of market timing here. We think the key question is: What is the empirical evidence of how the timing of an entry point into U.S. high yield affects an investor's potential forward return experience?

In Chart 3, using data from 2001 to the present, we plot monthly high yield index credit spreads versus the ensuing one- and three-year forward total returns. For some historical context, the average high yield index spread over this time was +575 basis points (bps) with one standard deviation of 276 bps, covering the approximate range of +300 bps to +850 bps. However, as we noted in an earlier commentary, the U.S. high yield market has actually increased in quality over time, so historical pricing benchmarks aren't directly applicable to today's higher quality market. Nonetheless, we have a few observations:

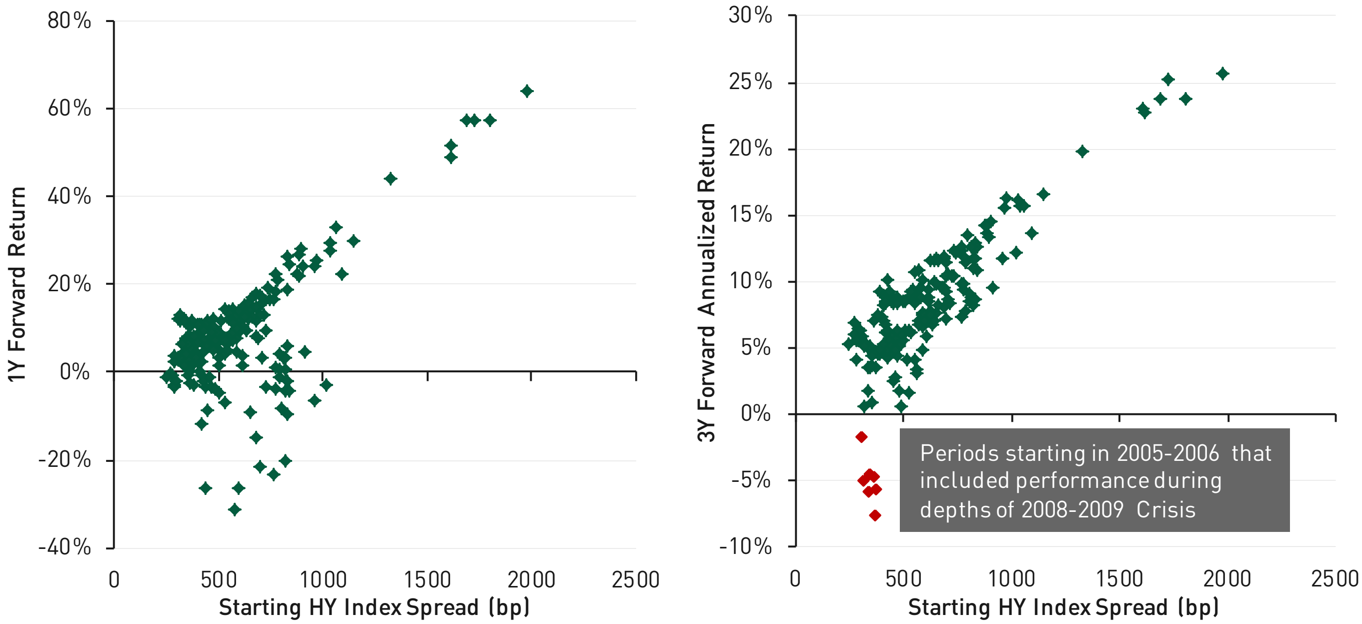
- While just looking over a one-year return horizon, negative returns have occasionally been part of investors' potential experience (as we similarly noted above in considering default experience). However, over a longer three-year ensuing period, negative annual returns have been far less common. Specifically, there were only seven out of 193 observed data points that saw a negative annualized return over a three-year window – essentially seven months of November 2005–May 2006 that all prefigured the depths of the 2008-2009 financial crisis three years later.
- Further, on a more granular basis using daily data, since 2001, there have been 939 days (or about 22% of the time) when the index spread was less than 400 bps and the median annual return in the following three years during this subset of periods was about 4.8%.
- Both these data points above bolster the case for a strategic, long-term allocation to high yield credit, in our view, when just considering today's entry point alone.

3. Coupon Remains the Key Driver of High Yield Returns

The discussion above essentially shows that market timing in high yield isn't an easy proposition. We think the case for a strategic allocation to high yield, rather than a tactical one, is reinforced by the fact that the vast majority of returns in high yield come from income that investors receive over time for taking on various forms of risk (default, ratings transition, illiquidity or other). At the risk of perhaps too liberally borrowing from equities, the adage of "it's time in the market, not timing the market that matters" applies to high yield as well, in our view.

Specifically, in Chart 4, we distinguish between the cumulative reinvested coupon return and price return across high yield since the start of 2009. Even with the historically low starting prices that prevailed at that starting point (around $60 for the broad high yield index and the mid $40s for the 'CCC'-rated component, compared to prices at or above par for the high yield, 'BB'- and 'B'-rated indexes today), price returns have been overshadowed by income returns by a multiple of nearly 3x to 5.5x with the passage of time.

Chart 3: Gauging the Relationship between Starting Spreads and 1- and 3-year Forward Annual Returns



Source: ICE BofA US High Yield Index, Lord Abbett & Co LLC. Data as of December 31, 2019. Chart depicts monthly high yield index credit spreads versus the ensuing one- and three-year forward total returns, covering the periods December 31, 2000–December 31, 2018 (one-year) and December 31, 2000–December 31, 2016 (three-year). The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results.

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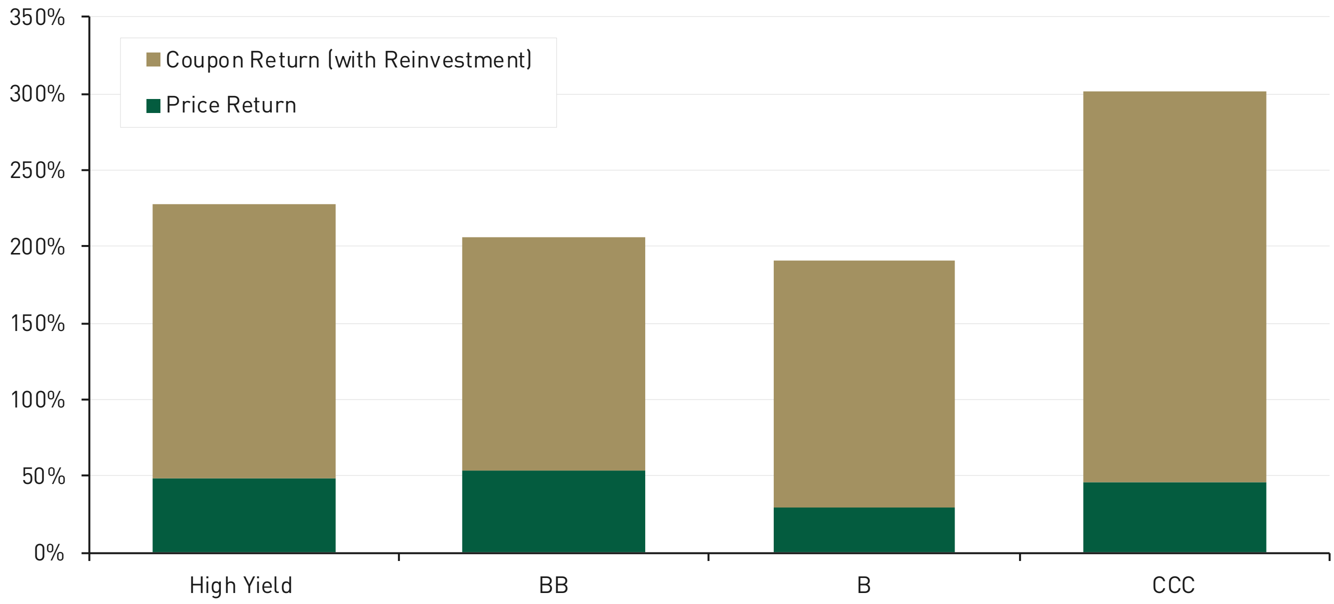
Chart 4: Over the Long Term, U.S. High Yield's Cumulative Price Return Has Mattered Much Less Than Its Income

Cumulative return breakdown from January 1, 2009–December 31, 2019



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Use History as a Guide, Not a Rulebook

In our view, investors may allow a "rear-view mirror" mindset and a tendency toward knee-jerk responses to negative market developments to get in the way of thoughtful, long-term asset-allocation decisions. Even at tighter-than-average spreads and a modestly elevated default rate, history shows U.S. high yield has proven to be a compelling income-oriented asset class for a strategic allocation. However, as always, we believe a differentiated strength of Lord Abbett's leveraged credit platform is our unconstrained approach, which enables us to vary the risk profile of our high yield strategy across the full spectrum of opportunities. And we believe that flexibility in portfolio construction, in light of both evolving valuations and fundamentals, is key as the credit and economic cycles progress.

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Important Information

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.

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Glossary of Terms

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

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 **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

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

The **Bloomberg Barclays US High Yield Index** covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

ICE BAML US High Yield Index tracks the performance of US dollar denominated below investment-grade corporate debt publicly issued in the US domestic market.

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