ABR Dynamic Funds’ Series on Stagnation Solutions: Part 3

High Yield Bonds

Preface

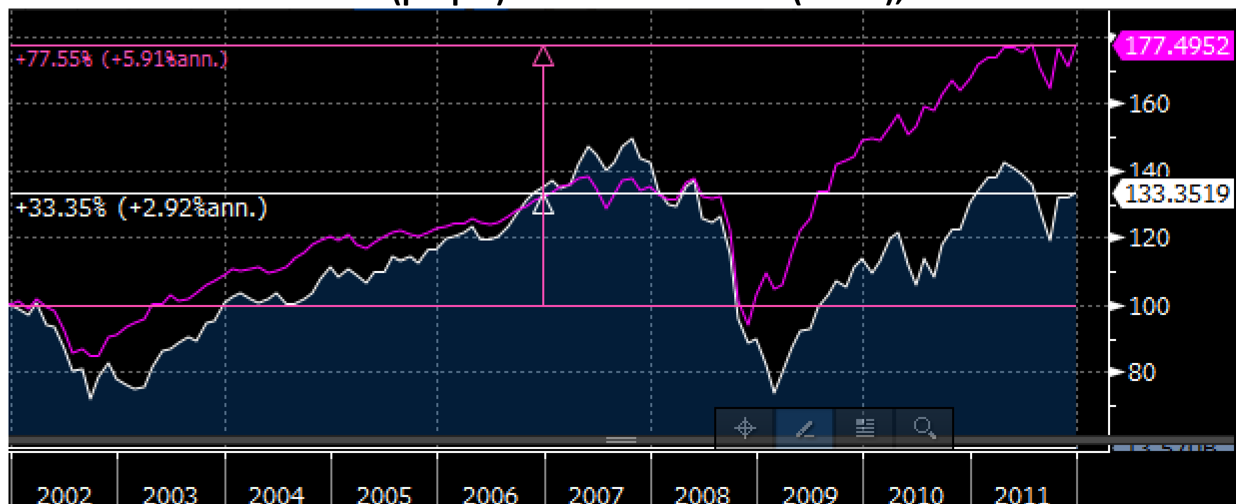
In the first installment, we noted that, at the time this series was written, the S&P 500 Shiller cyclically-adjusted price to earnings ratio (CAPE) was approximately 30 (of course, that can change quickly), and that value has historically indicated a next 10-year annualized return for the S&P 500 of about 3%. The last time the S&P 500 Shiller CAPE was about 30 was near the beginning of 2002. Over the next decade (2002-2011), the S&P 500 annualized return was 2.9%. Therefore, we have chosen that 10-year period to illustrate the equity replacement possibilities throughout this series. That choice reflects neither (1) a prediction that the next 10 years will play out just like the decade from 2002-2011, nor (2) a belief that the Shiller CAPE’s forecasts are quite that accurate over time.

High Yield Bonds

Proponents of high yield bonds often suggest they make good long-term equity replacements because they have offered equity-like return profiles with reduced swings. We disagree, when it comes to the long-term. Equity-like return profiles with reduced swings in both directions have mostly just meant that more capital had to be tied up in high yield bonds to achieve the same result for a portfolio than had to be tied up in equities. However, for investors expecting ~3% returns from equities, that long-term critique may not apply to the next decade. Currently, high yield bonds have about 5% yields, possibly making them worthy of consideration as replacements for part of a portfolio’s equity exposure.

The following graph shows a high yield bond index, the iBoxx USD Liquid High Yield Index (IBOXHY Index), which holds sub-investment grade corporate bonds. The time period shown is the decade from 2002-2011, for reasons covered in the preface. **As the graph shows, IBOXY Index meaningfully outperformed the S&P 500, producing a 5.91% annualized return over this decade (vs. the now familiar 2.92% for the S&P 500 Index).** As with all of the choices in this series, IBOXHY Index was chosen for illustration purposes, and not as an endorsement.

IBOXHY Index (purple) and S&P 500 Index (white), 2002-2011



Source: Bloomberg

Additional Observations

- Investors should consider the all-in yield to maturity, not just the coupon rate, as many high yield bonds are trading over par and should drop to par by maturity. At the time this was written, the all-in rate was about 5% for the index shown in this section, while the coupon rate was more like 6%.

- The IBOXHY Index also has the potential to underperform the S&P 500 Index. If the CAPE-based forecasts for the S&P 500 turn out to be wrong, and the next decade brings a raging equity bull market, that scenario would likely be one good candidate for this underperformance.

- The prevalence of "zombie" firms (defined as firms that are unable to cover debt servicing costs from current profits) has risen since the Financial Crisis (and even since rates started dropping in the 1980s). Investors may want to monitor the rise of zombie firms, the rise of corporate debt (which is at historically high levels based on the S&P 500 ex-financials), and the cost of financing that debt (which is not at such high levels, due to low interest rates). Defaults cut into returns (as they have in the past, including in the Financial Crisis of 2008, shown in the above graph).

- There isn't a lot of diversification value to any of the equity replacement ideas in this series, as they were chosen, in part, for their historical equity-like return profiles. However, the diversification value of this idea may be somewhat lower, if the bond portion of a portfolio already contains high yield bond exposure. Additionally, high yield bonds, if they were chosen for their equity-like return stream, should not be mistaken for a "safe" form of fixed income.

Next Week's Preview: Some international equity strategies have outperformed the S&P 500 during decades of lower S&P 500 returns.

Notes/Disclosures

Some of the indices may contain some hypothetical results. There are inherent limitations to hypothetical results. Past performance does not guarantee future results. No index presented in this installment is representative of any strategy at ABR Dynamic Funds, LLC. It is not possible to invest directly in an index. The information presented in this installment does not constitute a complete analysis of any index or strategy, and this installment contains no recommendation to buy, sell, or hold any investment. All data was obtained from sources believed to be accurate; however, ABR Dynamic Funds, LLC cannot and does not guarantee the accuracy of such data.