DECEMBER 2022

HIGH YIELD
MYTHS VERSUS REALITY

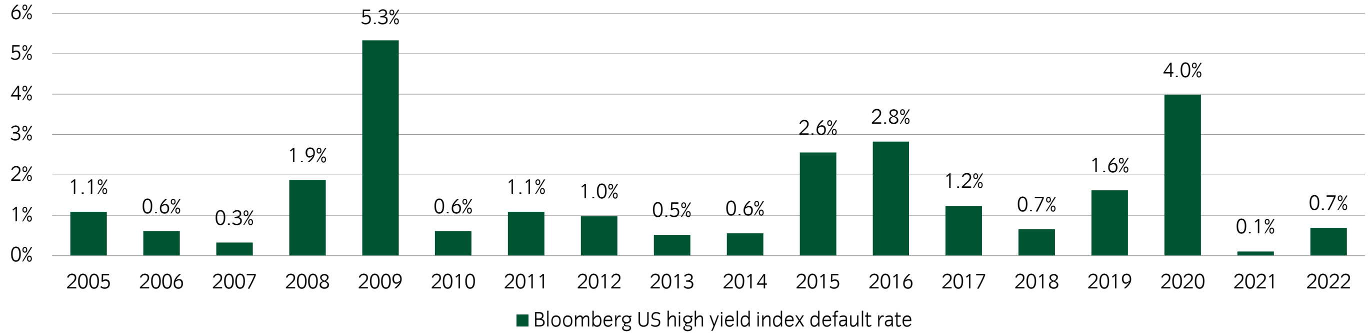
US HIGH YIELD CORPORATE CREDIT IS DIFFICULT TO IGNORE WITH YIELDS AT ~8.5%. ALTHOUGH INVESTORS NEED TO BE CAUTIOUS IN THIS UNCERTAIN ENVIRONMENT, KEY MYTHS AROUND THIS ASSET CLASS COULD HOLD INVESTORS BACK.

MYTH 1: DEFAULT RATES ARE BETWEEN 3% AND 5%

Reality: Default rates have averaged 1.5% pa

Many will be surprised to learn that the Bloomberg US High Yield Corporate Index[1] has only seen an average 1.5% pa default rate over the last 15 years (Figure 1).

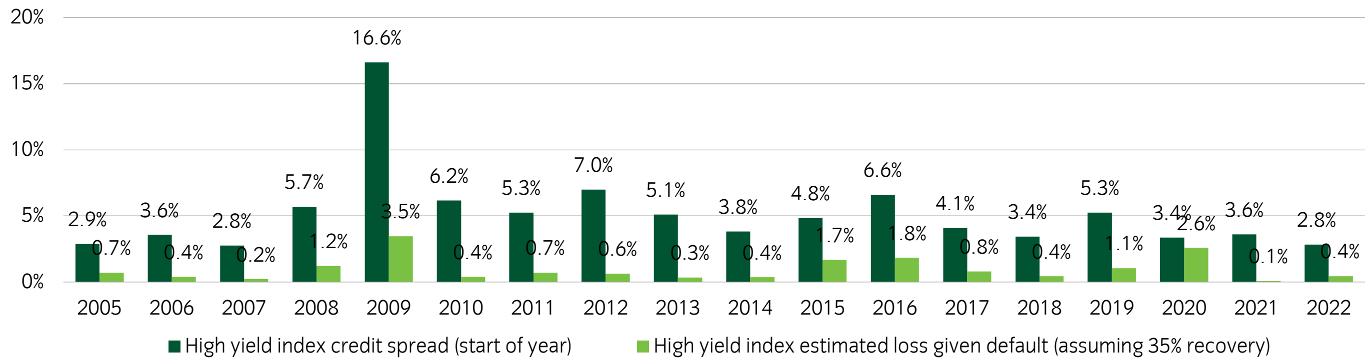
Figure 1: US high yield default rates have been a lot lower than you may think[2]



Historically, it has required a financial crisis (such as the start of the pandemic in March 2020 or the 2008 crisis) for US default rates to approach 4% or above. In 2021, defaults were the lowest in 15 years and have so far risen only to 0.7% in 2022 even as recession risks build. We expect default rates to remain within historical norms, but even in the event of crisis-level defaults, history indicates the pain will be far less substantial than most have been led to believe.

Assuming recovery rates of ~35%, (which is historically conservative[3]), high yield credit spreads have been priced to overcompensate for default risks (see figure 2).

Figure 2: US high yield spreads have offered compensation for default risks[4]

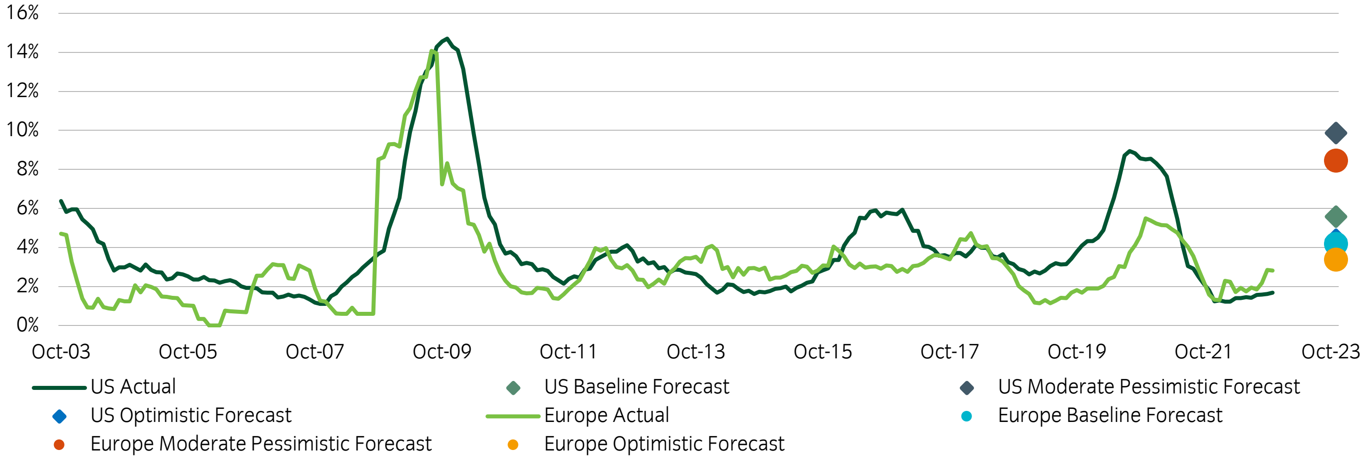


[1] See index descriptions at the back of the document
[2] Bloomberg, Insight calculations, December 2022.
[3] Moody's, December 2021
[4] Bloomberg, Insight calculation, December 2022.

Rating agencies report higher default rates

The high yield default rates investors are used to hearing from the ratings agencies are typically 3% to 5% on average, and much higher during periods of stress (Figure 3).

Figure 3: Rating agencies have reported higher default rates[5]



Ratings agency default analytics are not based on the high yield indices that investors are most likely to be exposed to, but the entire population of corporates for whom they have assigned a credit rating.

We believe these broader default samples are useful for top-down macro-level analysis or modelling. However, for high yield investors concerned about compensation for risk, index defaults have more direct relevance.

This is equivalent to how a climate scientist would never solely focus on global average temperatures to understand climate dynamics in the arctic – where temperatures are rising twice as fast.

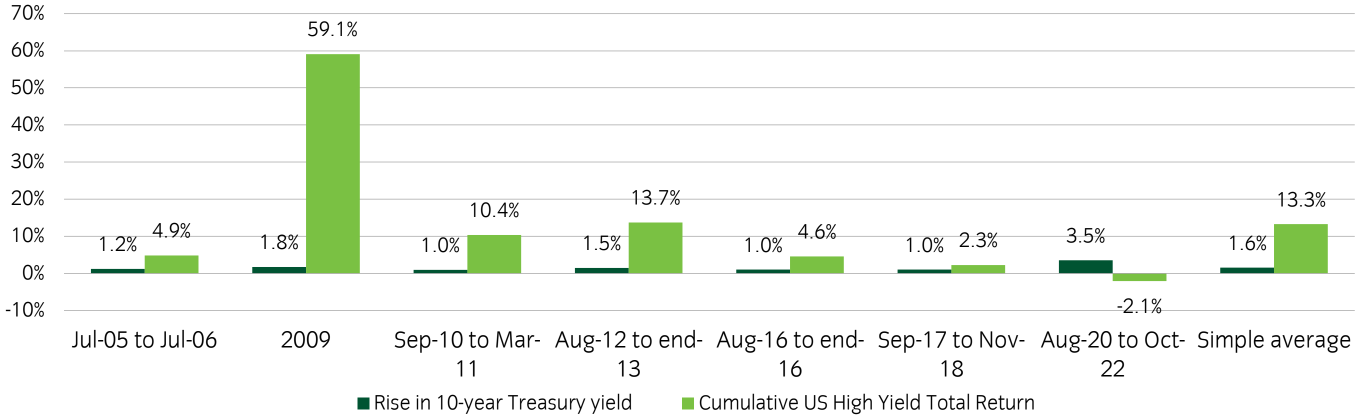
MYTH 2: HIGH YIELD IS VULNERABLE TO RISING RATES

Reality: High yield returns have been positive in rising rate environments

Since 2005, there have been seven periods in which 10-year Treasury yields have risen by ~1% or more

US high yield markets have consistently delivered positive total returns during most of these periods (Figure 4). The main exception has been the current period, which has not ended. We believe this could indicate a potential point for investors to consider high yield.

Figure 4: US high yield corporates have delivered positive returns during rising yield environments[6]



On average high yield returned close to 13% during these periods.

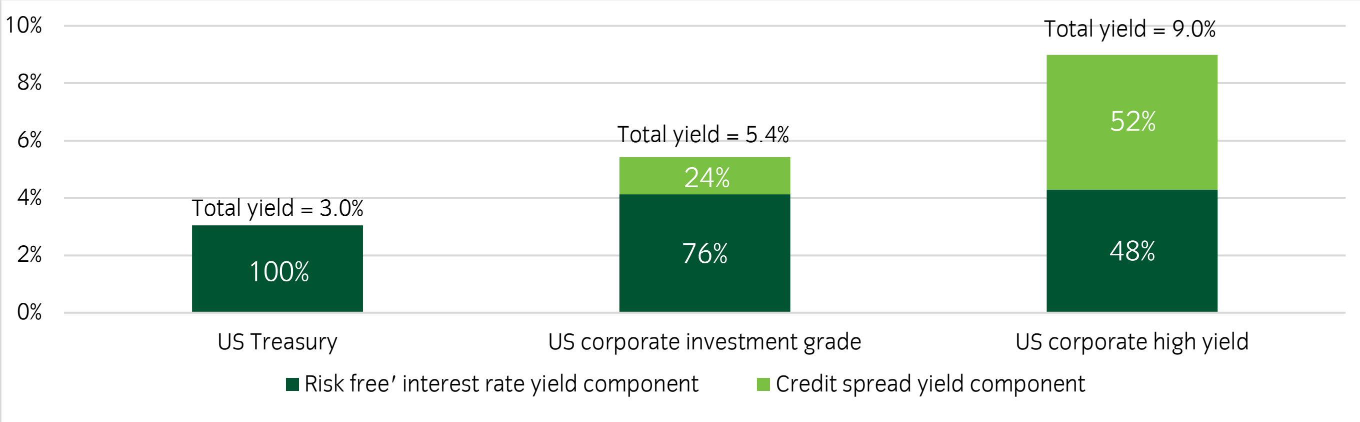
High yield is more naturally resilient to rising rates

High yield has less interest rate (or 'duration') risk than government or investment grade bonds, as high yield tends to be shorter dated on average.

Further, bond yields on high yield credit are mostly comprised of credit spread (Figure 5).

[5] S&P Global, December 2021.
[6] Bloomberg, Insight calculations, December 2022.

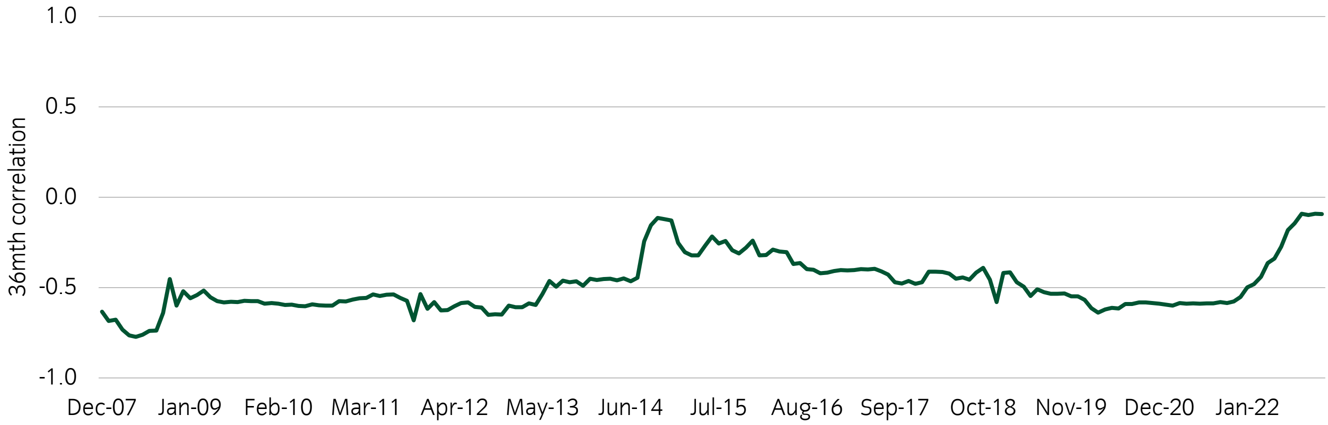
Figure 5: High yield bond have historically been driven more by credit spreads than interest rates[7]



As such, changes in credit spreads have had more of an impact on high yield returns than changes in interest rates.

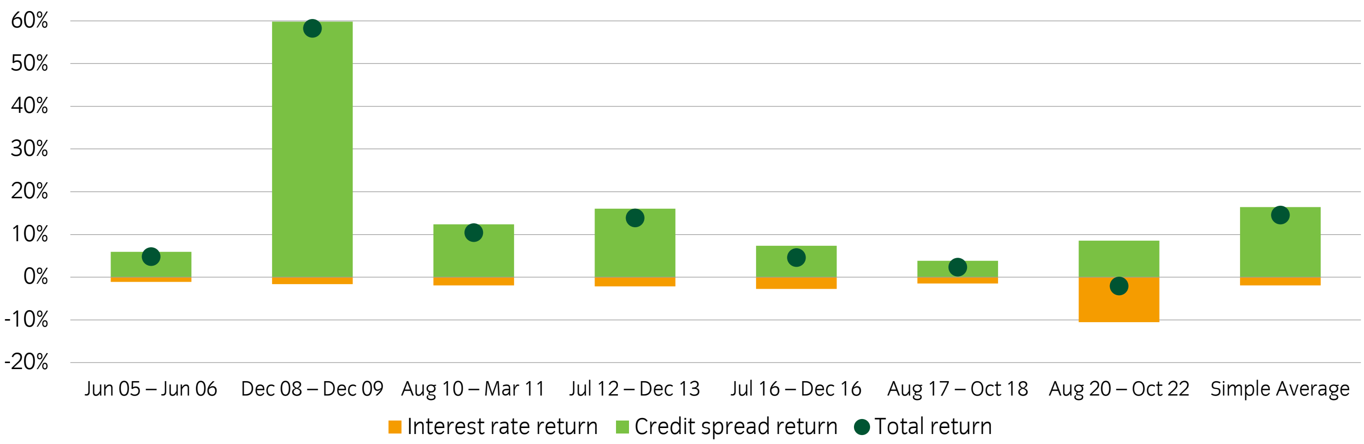
This is particularly important because interest rates and credit spreads tend to be negatively correlated (Figure 6). This is because central banks typically raise interest rates when the economy is growing, which is good for corporate balance sheets, and therefore credit spreads.

Figure 6: High yield credit spreads have been negatively correlated with their benchmark Treasury bond yields[8]



As such, when rates have risen, gains from credit spreads narrowing have heavily outweighed losses from interest rate risk in most cases (Figure 7).

Figure 7: Positive credit spread returns have far outweighed negative interest rate returns[9]



[7] Bloomberg, December 2022. Indices are The Bloomberg US Treasury Bond Index, The Bloomberg US Corporate Bond Index and The Bloomberg US Corporate High Yield Bond Index. Please see index descriptions at the back of the document.

[8] Bloomberg, December 2022. Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations. The performance results shown are net of investment management fees and reflect the reinvestment of dividends and/or income and other earnings. Please refer to the important disclosures at the back of this presentation.

[9] Bloomberg, December 2022.

MYTH 3: LIQUIDITY IS IMPOSSIBLE TO SOURCE

Reality: Specialists can tap 'hidden liquidity' from the ETF ecosystem

For most market participants, two-way liquidity in the high yield market did indeed deteriorate rapidly following the 2008 financial crisis, as new banking sector regulations took hold, making it less attractive for market makers to hold large inventories of bonds on their books.

As bonds are almost universally traded over-the-counter, one bond at a time, two-way liquidity became harder to source, particularly during times of market stress when the number of sellers overwhelmed buyers, exacerbating price swings.

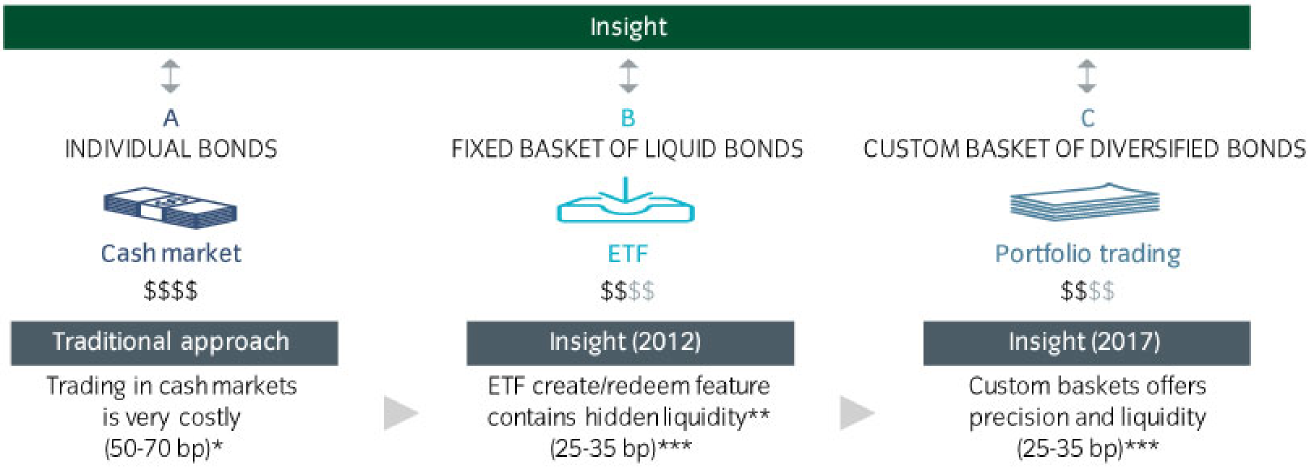
Other investors have found new sources of liquidity

However, after the 2008 crisis the fixed income ETF market developed rapidly, providing a new source of bond market liquidity.

Skilled investors experienced within the fixed income ETF ecosystem were therefore able to unlock 'hidden liquidity' within the 'create and redeem' feature, similar to the programmatic trading that has been a staple of the equity market for decades.

It has opened the door to trading large, customised baskets of bonds within hours for relatively low trading costs. In our experience, market makers even prefer trading diversified bond baskets because they can hedge them more efficiently and cost effectively.

Figure 8: The ETF ecosystem offers the potential to execute highly liquid basket trades[10]



In our view, this type of trading can help investors target alpha within smaller and traditionally less liquid issuers. Investors can also aim to eliminate much of the drag on returns imposed by high transaction costs.

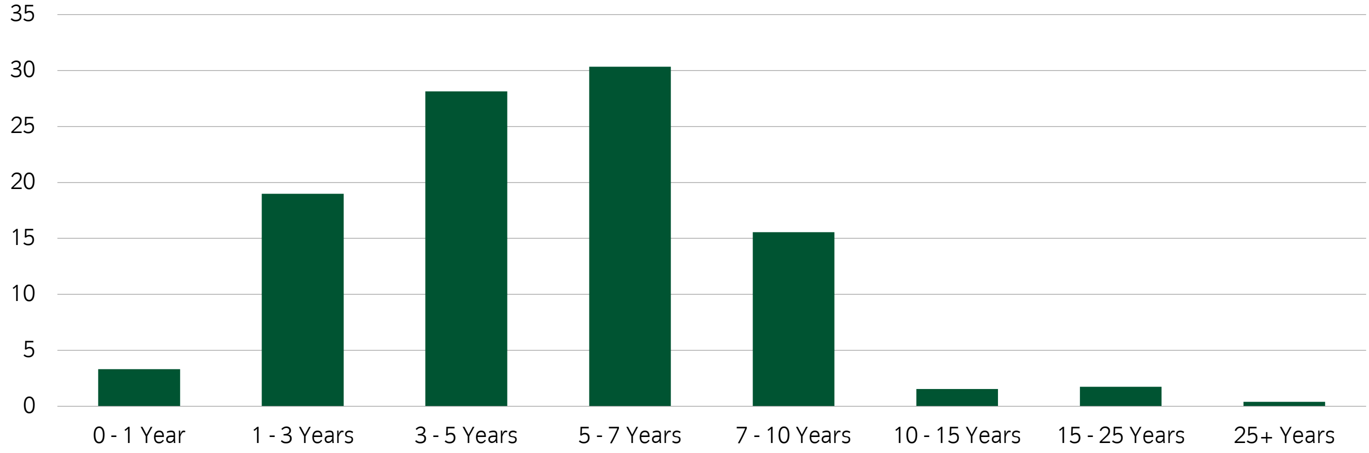
HIGH YIELD – THE ASSET CLASS TO WATCH FOR THE NEXT 12 MONTHS?

In our view – high yield corporate credit is emerging as an asset class to watch over the next 12 months. Last year's repricing of the asset class means it now offers investors an attractive yield. Although the global economy is contending with a slow down or even a mild recession, corporate balance sheets look resilient: leverage is below average and cash on books is above average, which suggests that defaults are likely to be contained. Against this backdrop, the yield investors can collect from high yield appears attractive. Moreover, high yield has held up well through conditions such as these, in contrast to equity markets which have tended to perform best during the highest growth periods.

Further, corporates are starting from a strong fundamental position. Most HY issuers took advantage of low rates over the past several years to shore up their balance sheets and refinance existing debt at lower rates. This has pushed out the maturity wall (see Figure 9) beyond one year and much of HY market will not need to access the debt market in the near future.

[10] For illustrative purposes only. Process presented represents that of predecessor firm Mellon Investments Corporation. Hypothetical trade example: actual trading may reflect prices from banks, bids and offers that are materially different than what is shown herein. Each account is individually managed and could differ from what is presented herein. *Extreme liquidity is in reference to the ability for investors to contribute and withdraw funds even in environments where liquidity is "extremely" scarce. **Hidden liquidity refers to potential liquidity sourced through basket trading of liquid and or diversified bonds. ***Represents typical range and subject to change. Insight makes no assurances that the bps represented on this slide will be within the range. Actual bps could be higher or lower than what is shown.

Figure 9: Maturity Wall: most high yield issuers will not need to access debt markets in the near term[11]



We believe investors can benefit from a greater understanding of the compensation for risk on offer in the high yield market. It could be a compelling time for investors to partner with managers able to overcome the high yield market's liquidity challenges, with the ability to fully understand and price market risks.

FIND OUT MORE

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Index definitions: Information about the indices shown here is provided to allow for comparison of the performance of the strategy to that of certain well-known and widely recognized indices. There is no representation that such index is an appropriate benchmark for such comparison. You cannot invest directly in an index and the indices represented do not take into account trading commissions and/or other brokerage or custodial costs. The volatility of the indices may be materially different from that of the strategy. In addition, the strategy's holdings may differ substantially from the securities that comprise the indices shown.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers

The Bloomberg U.S. Treasury Bond Index includes public obligations of the US Treasury, ie US government bonds. Certain Treasury bills are excluded by a maturity constraint. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

[11] Bloomberg, June 2022

- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

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