INVESTOR INSIGHTS

Looking under the hood at below-IG fixed income

APRIL 2024

Insights into the potential benefits and risks of below IG amid uncertain rates

At the beginning of 2024 there was little solid consensus on the direction of interest rates. Expectations for federal bank actions ranged from rate decreases for earlier in the year to rates remaining high until at least 2025. Such uncertainty can make things difficult for fixed income investors, as in many cases bond yields are highly correlated to interest rates.

In this environment, we believe that the below investment-grade fixed income market, that is mainly comprised of high yield bonds and bank loans, can provide a diversified source of total return that is less dependent on rates and rate expectations.

The US$4.5 trillion below IG market is a broad, deep and diverse one, with many structural characteristics that can benefit investors. At the same time, below IG fixed income has a different risk profile to investment grade markets that investors should understand as they consider expanding into this space.

Understanding below IG fixed income markets

Below IG fixed income refers to bonds or loans with a non-IG rating from one of the three major credit rating agencies – Moody's, Standard & Poor's and Fitch. A bond rated BB+ or lower by Standard & Poor's and/or Fitch and Ba1 or lower by Moody's is considered below IG.

The below IG rating implies that the fixed income security is considered higher risk than an IG bond. This may stem from, among other things, a weaker expectation of the company issuing the debt's ability to pay back the loan and/or to fulfill any other payment terms, the company being in an early or capital-intensive stage of its business, or an otherwise fundamentally sound company experiencing a temporary bout of weakness.

Below IG fixed income offers many potential benefits to institutional investors, especially its higher yield – the degree of risk present in the security means a higher degree of potential return to compensate for it. This higher yield sometimes results in below IG fixed income being perceived as having equity-like features, with higher returns than traditional IG bonds while retaining its structure as a debt investment.

As higher-yielding debt is often issued with shorter maturities (terms of 10 years or less) and higher coupons, below IG fixed income usually has a shorter duration and, consequently, lower sensitivity to changes in interest rates. There are also significantly more floating rate structures in below IG fixed income, providing more investment opportunities that are agnostic to the rate environment. We believe that all these characteristics combined could give below IG fixed income a more attractive risk–return profile during times of policy uncertainty.

High yield bonds vs. leveraged loans

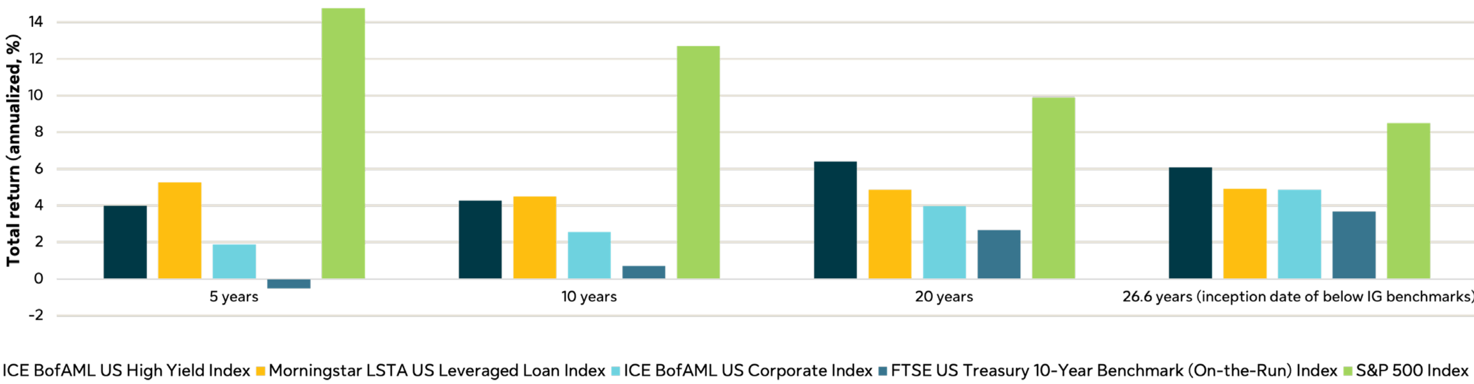
The below IG fixed income market has two main constituents: high yield debt and leveraged loans (also referred to as bank loans). Leveraged loans are generally secured against the issuer's assets and rank higher in the capital structure than high yield debt, which is typically unsecured. For this reason, high yield bonds can offer more yield to investors as compensation for the higher perceived risk.

Loans normally have floating rate coupons, meaning the coupons adjust as interest rates move, while high yield bonds normally have fixed coupons. Fixed rate instruments typically perform well when rates are falling, as the present value of the future coupons increases in a lower rate environment. Conversely, floating rate coupons can benefit investors in times of rising interest rates as they adjust to the higher interest rate environment.

Deeper insights into performance and volatility of below IG

In the following graph, we see the historical performance of below IG fixed income, as represented by the high yield and leveraged loan indices. While it is not surprising that below IG has offered higher historical returns than IG corporate bonds and Treasuries, it is noteworthy that as the time horizon extends, below IG returns begin to close in on the total return of equities.

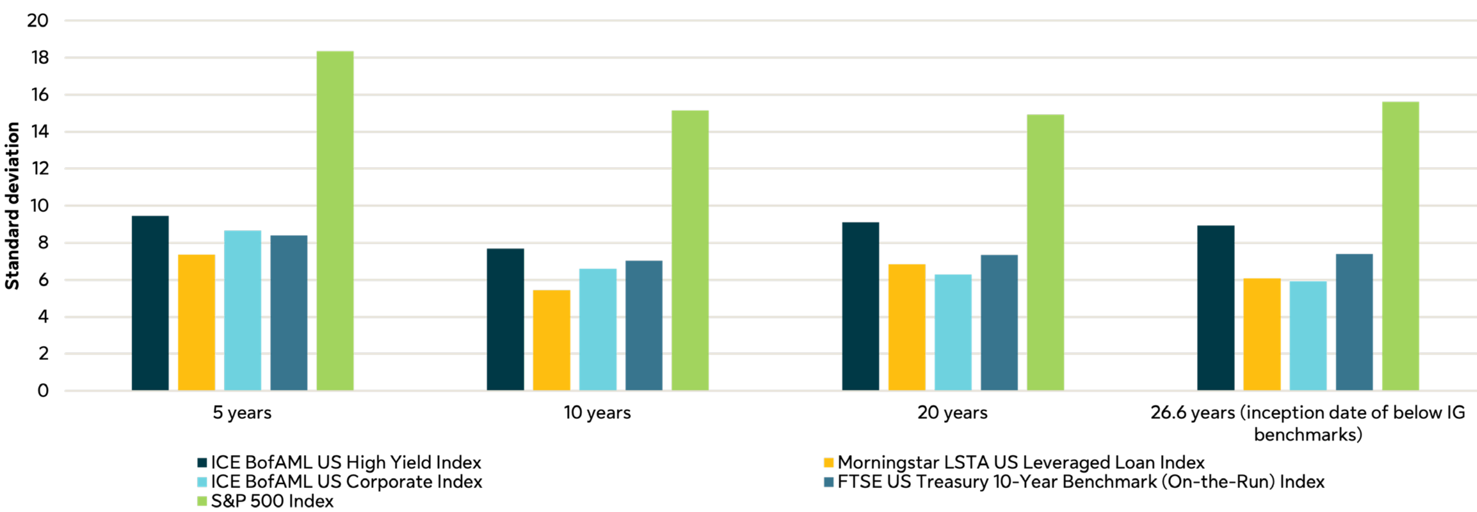
Total returns from below IG fixed income approach equity-like levels over time



Source: Bloomberg, as of February 29, 2024. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

Below IG's profile becomes more nuanced when we look at the volatility levels of the asset class compared to other investments. From the perspective of standard deviation, both high yield and leveraged loans exhibit less volatility than equities. It's interesting to note that by this measure, leveraged loans have a volatility profile comparable to the lower yielding IG corporate and Treasury indices.

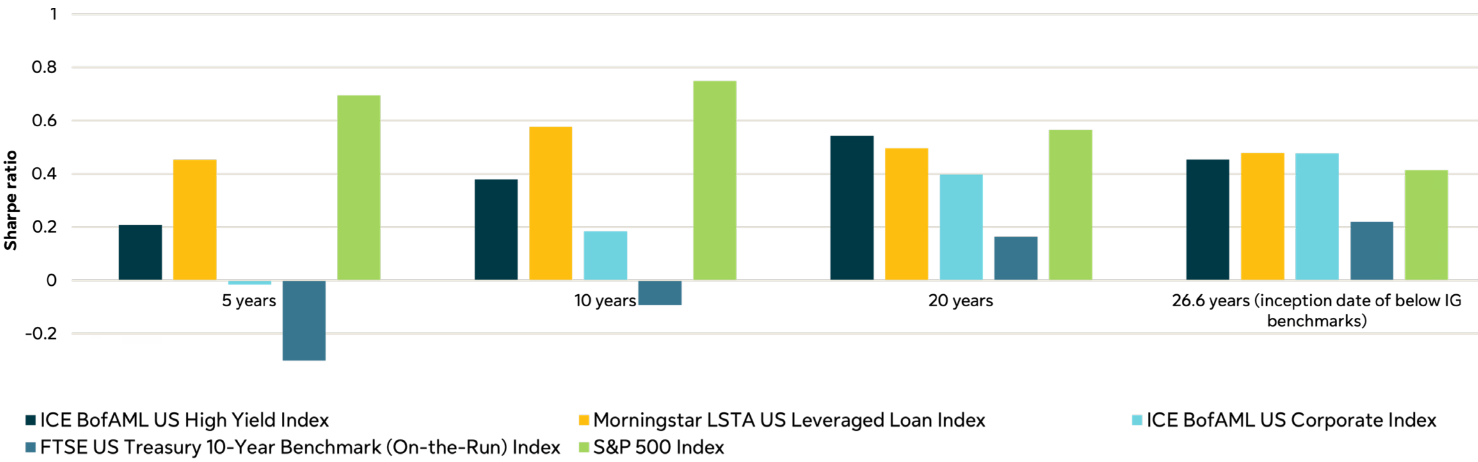
Below IG features considerably less volatility compared to equities



Source: Standard deviation of indices, Bloomberg, as of February 29, 2024. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

The volatility profile of below IG is even more interesting when we compare Sharpe ratios - which are derived from excess returns over the standard deviation of excess returns. We can see that the Sharpe ratio for both high yield and leveraged loans represent a higher investment risk than IG fixed income in the medium term, but over a long time horizon they become comparable to IG corporate bonds, though still with higher volatility than Treasuries.

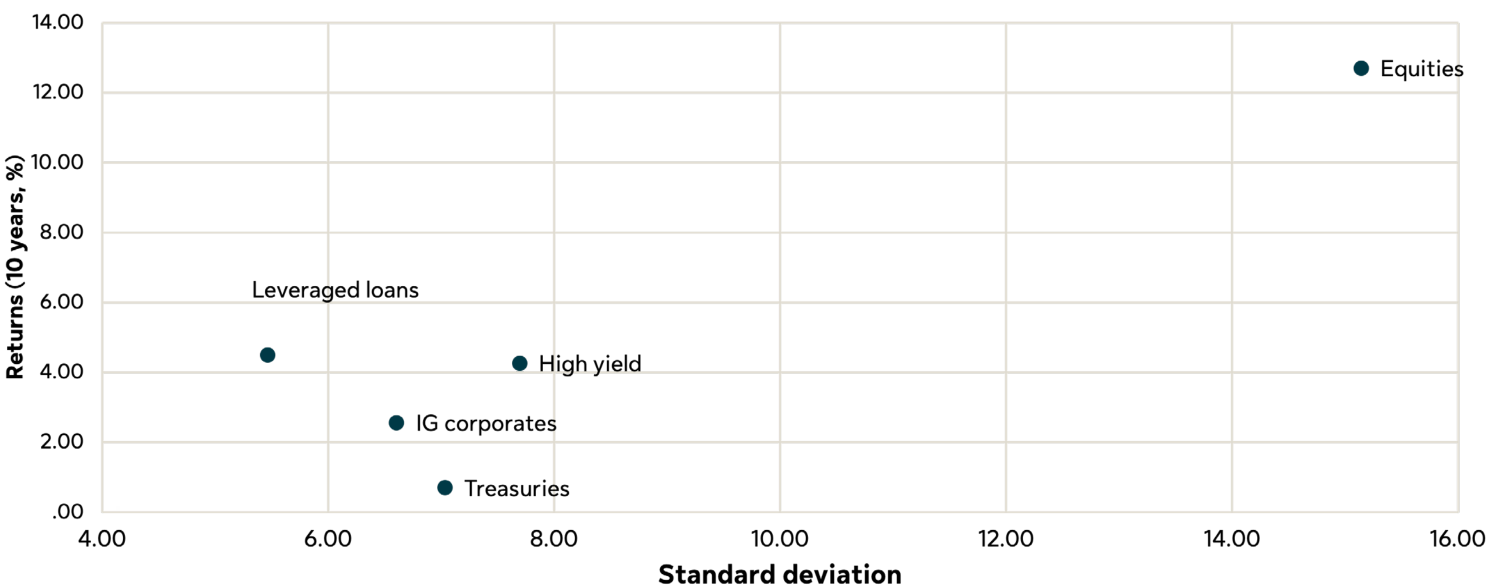
Below IG and IG corporates exhibit comparable volatility by Sharpe ratio



Source: Bloomberg, as of February 29, 2024. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

The following chart illustrates where below IG sits from a risk vs. return perspective.

10 year returns vs. standard deviation for below IG



Source: Bloomberg, as of February 29, 2024. High yield: ICE BofAML US High Yield Index; Leveraged loans: Morningstar LSTA US Leveraged Loan Index; IG corporates: ICE BofAML US Corporate Index; Treasuries: FTSE US Treasury 10-Year Benchmark (On-the-Run) Index; Equities: S&P 500 Index. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

Many investors also look to below IG fixed income as a diversifier to existing holdings. Diversification is gauged by a low correlation to other asset classes. Based on historical 10-year performance, we can see in the following matrix that high yield and leveraged loan investments have low correlations to Treasuries.

Correlations	ICE BofAML US High Yield Index	Morningstar LSTA US Leveraged Loan Index	ICE BofAML US Corporate Index	FTSE US Treasury 10-Year Benchmark (On-the-Run) Index	S&P 500 Index
ICE BofAML US High Yield Index	1.00	0.78	0.61	-0.07	0.67
Morningstar LSTA US Leveraged Loan Index	0.78	1.00	0.41	-0.30	0.49
ICE BofAML US Corporate Index	0.61	0.41	1.00	0.63	0.34
FTSE US Treasury 10-Year Benchmark (On-the-Run) Index	-0.07	-0.30	0.63	1.00	-0.17
S&P 500 Index	0.67	0.49	0.34	-0.17	1.00

Source: Bloomberg, as of February 29, 2024.

Summarizing the potential benefits of below IG fixed income

Below IG fixed income exhibits the following characteristics that can make it an attractive asset class for institutional investors:

- Higher yields than IG fixed income
- Equity-like return characteristics
- Less volatility (as measured by standard deviation) than equities over the longer term
- Comparable risk adjusted return characteristics to IG corporate bonds (as measured by Sharpe ratio) over the longer term
- Low correlations to Treasuries
- Typically shorter in duration and includes floating rate structures
- Pricing levels that tend to focus more on the underlying company's quality rather than the rate environment

Below IG fixed income, whether high yield debt or leveraged loans, can help many institutional investors meet the challenges they face in today's markets. The breadth of this asset class requires a high level of skill to help navigate it, however. So, in addition to the potential benefits and risk characteristics of the below IG asset class, investors should also consider the level of expertise, track record and network of resources of a given investment manager they partner with to access these opportunities.

Sources: Bloomberg, S&P Global Ratings, Fitch Ratings, Moody's Investors Service.

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