Mitch on the Markets

Are High Bond Yields Worth the Risk?

By Mitch Zacks
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For investors who retired in the last eight years or so, the yields in the bond markets have been – and I won't try to sugarcoat this – crummy. Yields on 'risk-free' 10-year U.S. Treasuries have fallen to near historic lows, and they barely pay an investor the long-term inflation rate. As of this writing, it hasn't gotten much better – the yield on the 10-year is around two and a quarter percent.

The low rate environment presents a quandary for some retirees who need to create passive income streams from their investment portfolio. If Treasuries only trickle free cash flow into a portfolio, it forces investors to seek alternatives. Dividend stocks are a solid choice, in my view, but they do come with the added risk of owning equities – which is perfectly fine for many but may push some investors further out on the risk curve than they are comfortable with. How is an investor to find the right balance?

Higher Yields Often Come with Higher Risks

Some have turned to high yield bonds to 'patch' the income need, but taking this approach has its risks. Just because a security is labeled a bond does not inherently make it safe. An emerging risk that I'm seeing is that demand in the market for higher yields is actually allowing companies with weak financials to issue bonds at lower than normal rates. But, investors are buying them up anyway. Accepting a lower yield for a risky product simply because there are not enough good alternatives in the market is a dodgy tradeoff, in my view.

The Bank of America Merrill Lynch U.S. High Yield Index is showing that investors are getting around 6% yields on the riskiest bonds in the market, which is the lowest it's been in over three years. Compare this to the 10% these bonds were fetching in Q1 2016, and you can see just how far the risk premium has fallen.

But, here's the kicker - the companies issuing these bonds have not necessarily gotten any more financially viable or stable in the last year, yet they have been able to issue new debt at lower rates in the market. How is this possible? Because investor demand –

the desperation for yield and the lack of alternatives – is allowing them to issue risky securities at a lower cost, in my view. Spreads between high-yield and Treasuries now are around half its normal historical level, indicating that the payoff is lower compared to the risk.

At the margin, I'm starting to get a whiff of trouble in the high yield space, though I'm not sounding any alarm bells just yet. According to Moody's, defaults have been staying pretty low, at 4.7% in Q1 with that number expected to drop in Q2. But, the growing investor demand coupled with corporations in the high yield space seemingly rushing to issue debt is concerning. High yield corporate issuance year-to-date is over 50% higher than the same period just one year ago, and corporate debt currently stands at some $8.5 trillion, over 50% higher than it was in 2008. Corporations are justified in taking advantage of the low rate environment, and many are deserving of the low yields they are able to fetch in the bond market. But some aren't, and investors should be operating with vigilance just as they do when buying equities.

I mentioned earlier that just because a security is labeled a bond does not make it safe. This is especially true in high yield sector. There are two main reasons why investors invest in the bond market. One is to generate income, and the second equally important reason is to diversify/lower the risk from equities. In a properly diversified account, not all of your investments should go up and down at the same time. High Yield bond returns have a tendency to move in lockstep with the equity market. It makes sense. At times when the economy is doing well and profits are up, both the stock market and junk bonds do well as investors feel the companies will be more able to pay off their liabilities. As the economy slows down or enters a recession, stock market declines, profits decline, and investors start to question which companies are going to be able to survive. The correlation of returns between the junk bonds and equity market is much higher than the overall bond market and the equity market. One doesn't have to go too far back to see how the junk markets performed during equity market duress. In 2008, S&P was down 37%, and the junk bond market lost 28%. Similarly, negative returns were present during the market downturns from 2000 to 2002. So, the safety that many investors were desperately looking for was not present and in fact exacerbated the situation.

Bottom Line for Investors: Exercise Diligence

At Zacks Investment Management, investments in bonds play a critical role in our overall wealth management strategy. Proper selection of bonds allows us to reduce volatility and lower the risk of our clients' total asset allocation, where fixed income is warranted and/or desired. As mentioned above, the fixed income portion of an investor's portfolio requires the same due diligence and attention as the equity holdings do.

Zacks Investment Management offers customized fixed income solutions for our clients to provide income, preserve capital and control risk. We also incorporate our client's tax situation and income needs into the management of the portfolio, often using other solutions like dividend stocks to increase overall yield. The goal is to create steady and predictable cash flow.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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