High Yield Bonds versus Equities: A Practical View

Summary
Let us begin by stating simply that we believe investors should be aggressively exiting equities in favor of high yield bonds. The cold reality is that the past 25-30 years have truly been the best of times for equity investors, yet high yield bonds have produced similar returns with much less risk.1 This includes a decade where stocks turned in their best performance in history!2 Additionally, over the past ten years, high yield bonds have meaningfully outperformed equities on an absolute basis, not even adjusting for risk.3 We expect that this outperformance is only in the beginning innings.

We believe that this reality will dictate a significant change in attitudes and thinking. Facts are facts. If high yield has outperformed equities with significantly less risk4, why would the allocation be 5% to high yield in a typical portfolio, while equities are given a 60% weighting? Shouldn’t the allocation be reversed? And what about the future? If you are responsible for a portfolio, either as the owner, a Consultant, a Trustee or an Investment Board member, how many years (or decades) do you wait for the supposedly magic returns of equities? How do Endowments meet their 5% distribution bogey without dipping into their principal? Or how do Pensions meet their 7-8% target and decrease their underfunded balance?

We see limited growth for equities for the foreseeable future, and most other fixed income alternatives are currently offering very little in the way of yield. Yet the high yield bond market has not only proven to outperform equities but offers a much better yield than both equities and various other fixed income asset classes. We anticipate that investors have a limited window to allocate significant resources to the high yield market and lock in what we see as very attractive yields. We believe that this window will ultimately close as more people recognize the opportunity, which will reduce the yields available.

Understanding Risk and Return
We will start with an education on what a high yield bond really is. Most investors falsely believe high yield bonds are riskier than equities. Fact: High yield bonds possess significantly less risk than stocks. This is because they are both higher on the capital structure of a

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1 The Credit Suisse High Yield Index, an index designed to mirror the investible universe of the $US-denominated high yield debt markets, posted an annualized return for the 25 year period of 12/31/86-12/31/11 of 8.83%, an annual standard deviation of 8.33%, and a return/risk of 1.06. The S&P 500 index posted an annualized return for the same period of 9.28%, an annual standard deviation of 15.78%, and a return/risk of 0.59. Credit Suisse High Yield Index data sourced from Credit Suisse. S&P 500 index data sourced from Bloomberg, using a total return including dividend reinvestment. Average Annual Return calculations are based on monthly returns.

2 For the period 12/31/90 to 12/31/00, the S&P 500 index posted a return of 299.8%.

3 See data and source details below.

4 See return/risk data in footnote 1 and additional returns data below.
corporation than equities (meaning they are the first paid back so their absolute risk is lower) and produce large income streams, which serves to lower the volatility (standard deviation).

Let’s look at some actual numbers. Both of the charts below demonstrate this key aspect of the high yield bond market: they provide better risk adjusted returns. First, when looking at the last one-, three-, five-, ten-, and 15-year periods, high yield bonds have performed better than equities and have done so with materially less risk (as measured by the volatility of returns).\(^5\)

**Average Annual Returns**

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<tr>
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<th>1 Year</th>
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<th>5 Year</th>
<th>10 Year</th>
<th>15 Year</th>
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<tbody>
<tr>
<td>S&amp;P 500</td>
<td>2.10%</td>
<td>14.10%</td>
<td>-0.26%</td>
<td>2.92%</td>
<td>5.45%</td>
</tr>
<tr>
<td>Credit Suisse High Yield Index</td>
<td>5.47%</td>
<td>23.00%</td>
<td>7.12%</td>
<td>9.07%</td>
<td>7.10%</td>
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**Average Annual Volatility**

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<th>10 Year</th>
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<tbody>
<tr>
<td>S&amp;P 500</td>
<td>15.93%</td>
<td>18.97%</td>
<td>18.88%</td>
<td>15.92%</td>
<td>16.59%</td>
</tr>
<tr>
<td>Credit Suisse High Yield Index</td>
<td>8.59%</td>
<td>9.84%</td>
<td>13.02%</td>
<td>9.94%</td>
<td>9.15%</td>
</tr>
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Then, extending that to the last 25 years, we see high yield bonds have produced returns relatively equivalent to equities, but with only about half of the risk/volatility as equities.\(^6\)

**Tail Winds Have Become Head Winds**
The return profile for high yield bonds is undeniable, yet investors still seem to be under the notion that equities are the only place where they can generate returns. Though an entire industry has been built upon the great promise that equities for the long run will provide excellent returns, the last ten years have put this notion into jeopardy, and we believe that the future does not look good.

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\(^5\) Credit Suisse High Yield Index data sourced from Credit Suisse. S&P 500 index data sourced from Bloomberg, using a total return including dividend reinvestment. Average Annual Return calculations are based on monthly returns. Average Annual Volatility is measured by the index standard deviation, calculated by annualizing monthly returns. All calculations are for the period ending 12/31/11.

Take a look around the globe and you will find that the developed world is in the midst of a massive de-leveraging cycle. This is not a garden variety recession where companies built up too much inventories and need to work them off. We need to work off trillions of dollars of debt accumulated over the past decades. Any student of history realizes that these are long and vicious cycles. Economic growth rates will be subdued for a long time. Is this an environment in which equities are likely to outperform? Doubtful.

During the past 30 years, we have seen incredible tailwinds for investors in the stock and bond markets. It is our belief that these tailwinds are now turning into headwinds. It is time to pull our heads out of the sand and deal with reality. The major themes we see for the next decade are as follows:

- **Interest Rates**: We believe that a steady three-decade decline in interest rates from a peak of almost 15% in 1984 is nearing the end. Though interest rates may fall a little further, they have limited room to do so. Falling rates have given a lift to all financial markets and provided investors with a false sense of return expectations.

- **Valuation**: With rates declining, equities have seen valuations (P/E or price/earnings ratios) rise farther and faster than in any time in history. This multiple expansion came to an end over the past few years and we expect that it is highly likely that multiples will compress further from here as we believe they will head toward historical lows. Note the parabolic and unprecedented rise in P/E ratios that happened between 1980 and 2000. So which is the outlier, that 20 year period or the 100 years of history prior to this? If valuations head toward the lower end of their historical range (P/E’s of under 10), earnings can remain strong yet stock investors can lose a great deal of money. This is why active management in equities may not save investors. You can be right about the company and still lose money because you are betting on the equity market for the value to be realized.

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• **Demographics:** Supply and demand remains a very key variable for the price of all goods and services, stocks included. The U.S. population demographic that provided for the accumulation of equities over the last 30-40 years has shifted. Defined benefit pension plans, which were responsible for a great deal of steady equity demand, are being terminated/frozen and participants are in distribution mode. The dominant Baby Boom generation is in the beginning stages of selling assets, which will have an effect on the demand for everything from houses to stocks. What are retirees interested in? Yield—with a lack of steady employment income, yield or income from their investment portfolio becomes all the more desired and necessary.

**Generating Yield—Dividends versus Bond Interest**
What about the notion of generating this income through dividends? At its surface, there is nothing inherently wrong with this thought. There is actually a massive body of research that shows most, if not all, of the historical returns from stocks came from the dividend and the reinvestment of dividends.

Here’s the problem: unlike bond interest, a dividend is not a contractual obligation. It is paid to investors out of after tax profits. The dividend can be cut or eliminated at any time and for any reason. And over the past several decades we have seen fewer and fewer companies paying dividends or paying very low dividend yields.9

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8 [www.multpl.com](http://www.multpl.com), data courtesy of Robert Shiller, Yale Department of Economics.
Yet, bond coupons are a contractual obligation of the company and interest is paid prior to taxes. There is simply much more predictability and sustainability to an income stream generated in this way. So for those looking to generate substantial income, as well as long-term returns potential to meet their investment targets, we feel you will have no place to look except the high yield market.

**High Yield Bonds as a Core Holding**

As investors look at where to participate in the high yield space, we believe strongly in the notion that the high yield bond asset class needs to be actively managed. There are index-based, unmanaged ETFs and mutual funds backed by high yield bonds, but these products possess hundreds of bonds, often multiple tranches of the same large issuer. Additionally, these products have become trading vehicles for the “risk on, risk off” crowd, not a core part of a portfolio. Given our belief that high yield should definitely be a core part of an investment portfolio, our goal with our actively managed high yield products is to provide investors with a significantly higher yield than these index-based, unmanaged funds offer and we would expect to reduce risk through our active approach.

**Actively Managing Risk**

The ability to manage risk is what active management is all about. Bond investors have a number of risks, including the following:

- **Interest Rate**: If rates rise, the common rule of thumb is that bond prices will fall. However, high yield bonds are generally not sensitive to interest rates and have short durations. Typically rising rates are associated with strengthening demand for money. Demand rises with an improving economy. As the economy improves, high yield bond prices tend to rise as the perception of credit risk diminishes. Additionally, the higher coupons and generally shorter maturities provided by high yield bonds dampens that interest rates sensitivity and leads to lower durations versus the various fixed income alternatives, such as Treasuries, investment grade corporate bonds, and municipal bonds.

- **Liquidity**: This refers to the ability to enter and exit bond positions quickly and with limited price impact. High yield markets are typically quite liquid, as compared to municipal or investment grade bond markets. However, with the ETF format this is even less of a concern for investors as they can buy or sell shares whenever they choose. With the creation and redemption of shares by market makers, liquidity is always available in these vehicles. Furthermore, while the level of liquidity in ETFs is equivalent to that in public equities, investors have an additional benefit in that pricing of the ETF is dictated largely by the value of the underlying securities (net asset value of the portfolio) rather than the supply and demand of the fund shares. This means that large orders can generally be traded without having a massive pricing impact.

- **Event**: Event risk applies mainly to corporate bonds issued at a rating of BBB or higher, known as investment grade. Most of this market does not have protective covenants for bondholders, which allows for subordination. If a private equity firm launches a takeover of a firm that has issued bonds without this protective covenant (known as a poison put or
change of control covenant), they can layer on debt ahead of the existing highly rated debt, effectively subordinating and destroying value for existing bondholders. We have rarely, if ever, seen an original issue high yield bond without a poison put, so in this case, if a takeover, acquisition, or merger results in the issuance of a significant amount of additional debt, the company is required to offer to take out the existing bonds at par or above. This in effect eliminates event risk for the high yield market.

- **Credit:** Credit risk is the primary enemy to be dealt with for high yield investors. While keeping defaults to a minimum is the primary endeavor of active management, the most important literal statistic is not default rates, but loss rates. This is because even when bonds default, they can often recover a significant percentage of their original issue value. In some cases, bonds actually rise after a default.

**Peritus’ Approach**

We have always maintained that our responsibility is to manage risk, not manage money. We would encourage all investors to read our whitepaper, *The New Case for High Yield*, which provides much greater detail into the market and our thoughts on managing high yield credits. However, we will highlight some of our most important concepts for investors.

In simplifying how we manage our portfolio of high yield credits, it is perhaps more important to talk about how and why we view the world differently from our competitors. First, as we have stated over the years, the rating agencies play little role in our work. This is ironic as the Government (through Dodd-Frank legislation) is now trying to eliminate all reference to using ratings to determine capital allocation for banks. What this means is that sector or segment issues (BB vs. B, B vs. CCC, etc.) are complete nonsense to us. We hear a great deal of chatter about “high-quality high yield,” which references BB bonds over single B or lower bonds. This is complete and utter stupidity in our minds. This is what we like to call the “cream of the crap” pitch. We see no relative value, as these bonds carry similar risks but offer less yield to investors. As we have stated before, credit is AAA or D. A bond is a loan to the issuing company and either they pay you back or they don’t. If the credit is rated BB versus B or CCC, so be it.

As we begin our analysis, we ask two fundamental questions of our companies: what are you selling and who are you selling it to? We look at companies that have a reason to exist and a consistent demand for their product or service. We want a recession resistant demand profile for our businesses.

Next, we want to make sure that the business has the ability to generate free cash flow (“FCF”). We describe this as cash flow from operations and then subtract capital expenditures. This is evaluated over a period of years, as we want to capture both good years and bad. This FCF calculation takes into account various sources and uses of cash, including working capital issues. A simple example will explain the importance of this. Company A sells widgets. They have a couple of customers. Once the company ships the widgets, Company A books the revenue and may possess a very attractive income statement. But if they never get paid on their receivable, the standard EBITDA calculation won’t save anyone and they will never generate any cash.
In short, we focus on the fundamentals of a company to determine where we see the best risk/return investment opportunity and allocate our investment dollars accordingly. This focus on risk/return is of paramount importance. As we work to maximize yield, we evaluate whether we feel we are getting paid for the risks we assume. One of the most important weapons against losses is the significant spread or yield advantage enjoyed by high yield investors. If a 5-year Treasury bond is yielding 2%, and a 5-year high yield bond (portfolio) is yielding 10%, this 8% per year yield advantage can cover a variety of sins.

Finally, valuation matters. While EBITDA (earnings before interest, taxes depreciation and amortization) is not cash flow, it remains an important metric. Both bankruptcy courts and banks/investment banks use Debt/EBITDA and EBITDA/Interest for valuation and refinancing purposes. Market adjusted debt/EBITDA ratios over 5-6x can be challenging to refinance or produce capital structures with little ability to delever; therefore, we do pay attention to this metric. We have blogged in depth about the massive leveraged buyouts of the 2006-2007 period. Many of these companies have leverage metrics well over this 5x level, resulting in capital structures that we view as unsustainable and expect them to default or engage in distressed exchanges over the coming year or two. These sorts of credits are very well represented in the risk on risk off trade (e.g., in the index-based, unmanaged products), yet are names that we can and choose to avoid as active managers.

Similar to value investors in the equity business, we possess a contrarian bent. The difference in using a valuation methodology in credit versus equities is dramatic. A bond is a contractual obligation that pays interest (accrues it every day) and has a maturity date (exit strategy). This results in an analysis that is effectively a negative art form. We need our companies to keep the bills paid and generate some cash at the end of the day. The stock investor who buys cheap can watch in dismay as the stock continues to get and stay cheaper. We believe that the stock market of the future will inflict this pain on many investors as a dollar’s worth of earnings will be worth less than recent history has provided. Couple this yield and exit strategy advantage provided by high yield bonds, with a thoughtful (yet paranoid) lender mentality, and we believe you have a recipe for investment success.

**New Reality**

We believe it is time that investors and investment advisors wake up to the new realities of the world. The notion of equities magically compounding money at double digit rates should have been put to death over the past decade where the S&P 500 has effectively returned nothing. Amazingly hope springs eternal, as both pension accounting and many investment boards and consultants continue to spew the dribble that the next decade will be terrific for equity investors. How has that worked out for everyone in 2011? Another zero for the S&P 500. To us stocks remain hope certificates, but it is difficult to pay bills with hope. We prefer steady and predictable cash flows generated by a carefully managed high yield bond portfolio.

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10 For the period 12/31/01 to 12/31/11, the S&P 500 Index has returned 0.92% on an annualized basis. For the period 12/31/10 to 12/31/11, the S&P 500 Index returned 0%.
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