Understanding High-Yield Bonds

Diversification is widely recognized as one of the most important features of a well-constructed investment portfolio. But diversification is important not only across asset classes, but also within asset classes. Within fixed income, opportunities to diversify are quite numerous, as the asset class is characterized by a very broad opportunity set.

With yields near historic lows, many investors are looking for diversification opportunities that can increase their portfolio's income potential. One of the most common ways of achieving this goal is to invest in high-yield bonds.

What are high-yield bonds?

In general, fixed-income securities can be categorized into two broad categories: investment grade and high yield. The categories are based on an assessment by credit rating agencies of the debt issuer's ability to meet its financial commitments. As an example, this is how Standard & Poor's, a major credit rating agency for bonds, determines the default risk of a bond issuer:

Credit rating	Standard & Poor's rating	Description
Investment grade	AAA, AA, A, BBB	Issuers have an adequate (BBB) to extremely strong (AAA) capacity to meet financial commitments.
High yield	BB, B, CCC, CC	Issuers currently show a degree of vulnerability to defaulting on their financial commitments, with CC-rated issuers being more vulnerable and BB-rated issuers less.

Source: Standard & Poor's.

The higher coupons on high-yield bonds are intended to compensate investors for the higher level of risk they are taking relative to investment grade bonds. Importantly, active mutual fund managers can implement a variety of strategies to mitigate these additional risks. Another factor to keep in mind is that high-yield bonds sit above equities within a company's capital structure. This means that if the company found itself in a liquidation scenario, holders of high-yield bonds would be paid before equity holders.

In addition to offering greater income potential, high-yield bonds behave differently than investment grade bonds in a variety of common scenarios. A key reason for this is that high-yield bond prices tend to be driven more by the economy and company-specific fundamentals than by interest rates.

The table below illustrates how high-yield bonds compare to investment grade bonds:

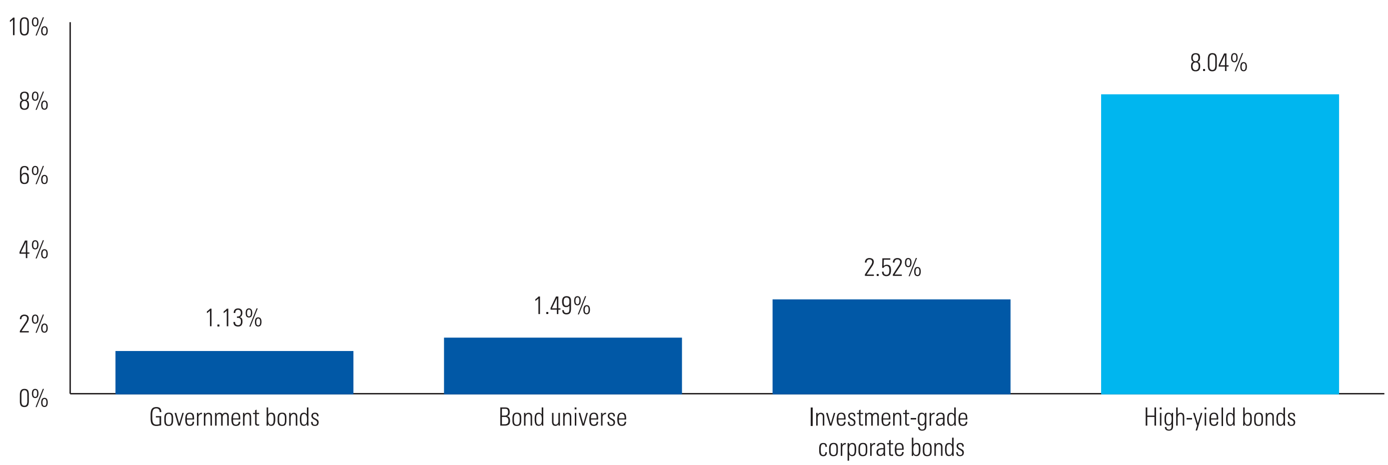
Credit rating	Investment grade bonds	High-yield bonds
Yield generation The amount of income generated by the security.	Lower	Higher
Interest rate risk The risk that rising interest rates will cause bond prices to decline.	Higher	Lower
Credit risk The risk that the issuer of a debt instrument defaults or becomes insolvent.	Lower	Higher
Inflation risk The risk that inflation will cause an erosion of purchasing power.	Higher	Lower
Relative general performance characteristics	Typically underperforms in a rising interest rate environment or inflationary periods. Typically outperforms in periods of high market volatility.	Typically outperforms in a rising interest rate environment or inflationary periods. Typically underperforms in periods of high market volatility.

These differences are what make high-yield bonds a diversifying complement to investment grade within a well-constructed fixed-income portfolio.

Higher yields equal higher income

The historical yield advantage of high-yield bonds over other sub-asset classes within fixed income is quite pronounced, and presents an attractive opportunity to enhance your portfolio's total return.

Fixed-income yield comparisons

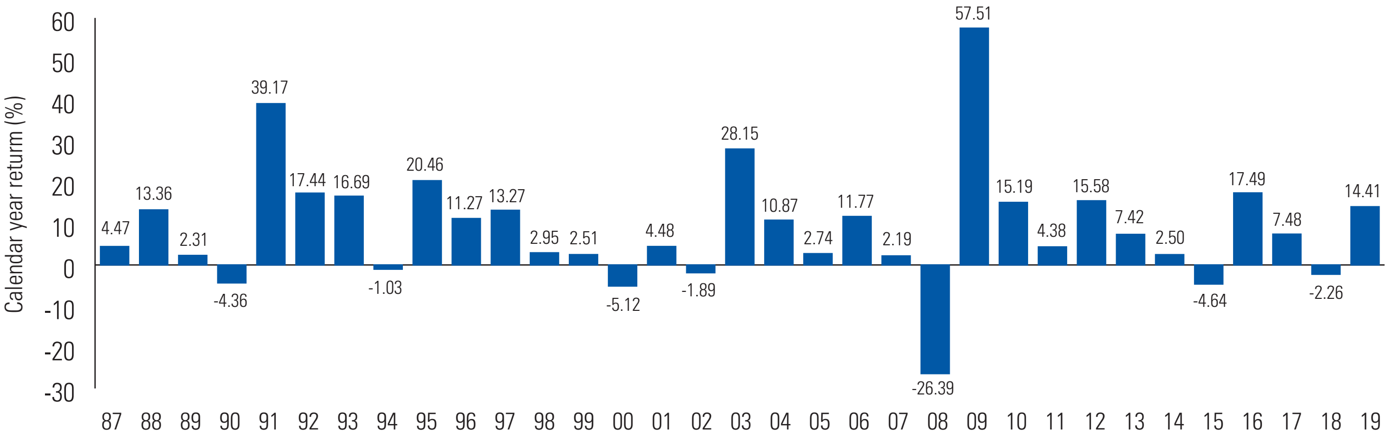


Source: PC Bond, ICE Data Services, as at April 30, 2020. Government bonds represented by FTSE Canada All Government Bond Index; bond universe represented by FTSE Canada Universe Bond Index; investment-grade corporate bonds presented by FTSE Canada All Corporate Bond index; high-yield bonds represented by ICE BofA U.S. High Yield Index.

Long track record of strong performance

Since the inception of the high-yield index, the asset class has recorded only seven negative calendar year returns out of 33.

Calendar-year returns for high-yield bonds



Source: Morningstar Direct. High-yield bonds represented by the ICE BofA US High Yield Index (USD).

In summary, high-yield bonds may be suitable as a complement within an income portfolio, as they offer higher income potential and increased diversification.

iA Clarington's lineup of high-conviction, actively managed mutual funds includes a number of mandates that offer diversified exposure to high-yield bonds. Contact your financial advisor to learn if an allocation to high-yield bonds is right for your unique objectives and needs.

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