

How ‘high’ is high yield at this point?

High-yield bond performance has delivered strong returns to its investors – both in income and capital appreciation. Investors’ global search for yield has created insatiable demand for these securities and has resulted in high yields touching all time lows in September. High-yield securities currently offer an attractive investment opportunity as high-yield companies exhibit strong fundamentals. But despite a dramatic decline in yields, strong fundamentals and an asset class that delivers strong risk/reward characteristics, the question posed by many is: **have high yield bonds run their course?**

U.S. high yields reached an all-time low of 6.1% in mid-September, significantly lower than the 25-year average of 10.1%¹. If you consider that the average yield for investment-grade corporate bonds over the same time period is 6.5%, one can see how low yields are on both an absolute and relative basis. However, high-yield bonds can still claim their “high” yield nomenclature on a relative basis when looking at current yields on investment-grade corporate and government bonds, which have an average yield of 2.8% and 0.8%²

(Figure 1), respectively. With such low yields available elsewhere to investors, it is fairly obvious to see why the asset class has experienced strong new issuance and flows over the last few years (Figure 2). In fact, issuance and demand year-to-date, has already surpassed the annual total for 2011³.

Figure 1

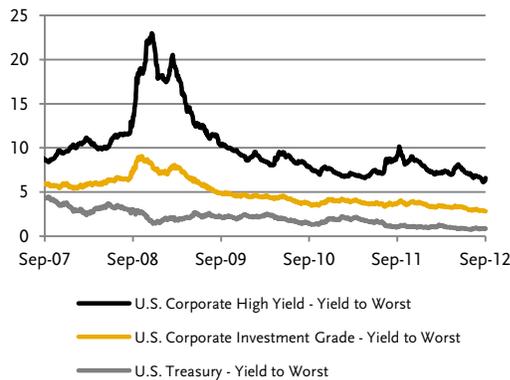


Figure 2

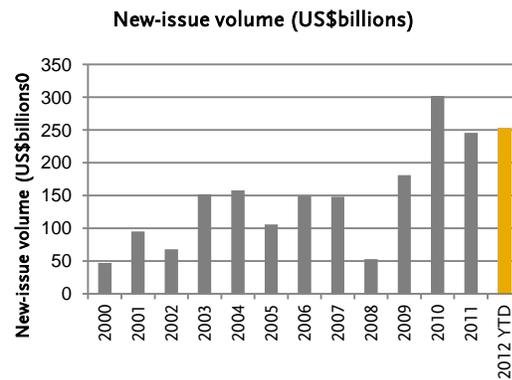


Figure 1 source: Barclays Capital as of September 26, 2012. Figure 2 source: JP Morgan.

¹ Source: Barclays Capital, as of September 26, 2012.

² Source: Yield to Worst, Barclays Capital as of September 26, 2012.

³ Source: JP Morgan, as of September 21, 2012.

Is the strong run in high yield over?

With yields at all-time lows and a strong track record of performance behind it, the question arises: **has the run in high yield run its course?** That is, have the yields overshot on the downside in the global search for yield? “The consensus certainly calls for a reversal given such a run. I still contend that the high-yield rally has yet to run its course,” says **Tom Nakamura, Vice-President & Portfolio Manager**. “While the absolute valuation arguments have largely been exhausted, there is still sound relative value to feed the overall rally,” Tom adds.

Here are some arguments supporting a further run in the asset class:

Relative value

1. Overall U.S. high-yield spreads

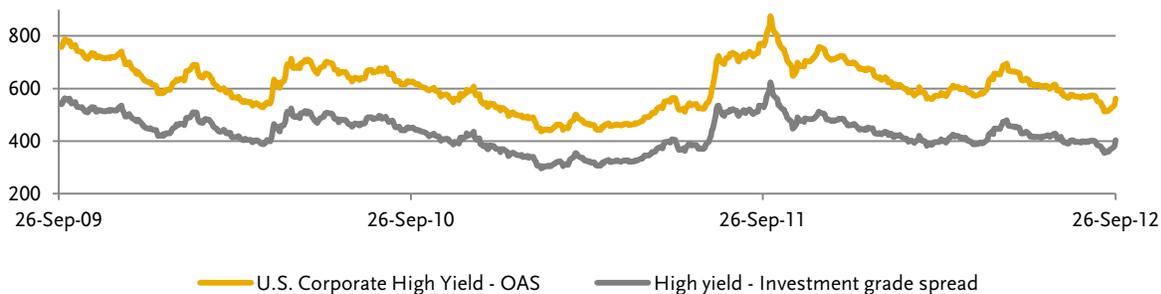
U.S. high-yield spreads have tightened 120 basis points from 682 basis points at the start of the year to 562 basis points currently (**Figure 3**). However, current spreads are still 126 basis points wider than their three-year lows, reached on February 8, 2011, leaving room for further spread tightening and capital appreciation potential⁴.

2. High yield vs. investment grade spreads

Spread differentials between high-yield and investment-grade corporate bonds have not reached new lows, supporting the attractiveness of high-yield bonds relative to investment-grade corporate debt. High yield currently offers a 404 basis point spread pickup (**Figure 3**). This is still well wide of recent lows set on February 8, 2011 of 296 basis points, and considerably wider than the last time we know that credit markets were in a frothy bubble, which occurred prior to the 2008 financial crisis when spreads got to as low as 143 basis points on May 22, 2007⁴.

High yield spreads over Treasury bills were 562 bps⁴ compared to a 300-400 bps⁵ range, which is typical during a low-default environment like the one we are currently in. In fact, high-yield default rates are currently 1.8%⁵, which is very low on a historical basis. The long-term (25-year) average default rate for high-yield is 4.2%⁵.

Figure 3



Source: Barclays Capital data to September 26, 2012.

⁴ Source: Barclays Capital, as of September 26, 2012.

⁵ Source: JP Morgan, High Yield and Leveraged Loan Research, September 21, 2012.

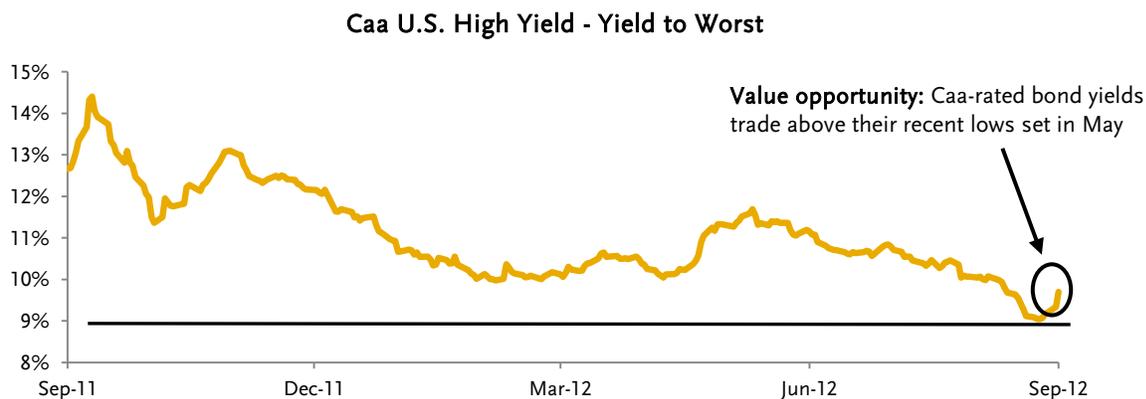
3. Caa-rated bond yields are wide of all-time lows

High-yield investors have bid up the prices of higher-rated high-yield bonds such as Ba-rated bonds and B-rated bonds, at the expense of lower-quality bonds, such as Caa-rated bonds, because of increased investor concern over the global macro environment and in particular, recession-related concerns. This has resulted in U.S. high yields, including Ba and B-rated bonds reaching record lows in September.

“However, we have not seen the same relationship hold true for Caa-rated bonds. “We believe there is still value in Caa-rated credits and high yield in general,” says Tom. “This view is predicated on the continuation of liquidity from central banks and the economy being able to avoid down-side tail scenarios, which Caa-rated bonds are particularly sensitive to.” “In terms of the former, earlier action by the Federal Open Market Committee this month has provided a bold check mark and on the latter, there continues to be risks in the global economy, but the recent aggregate policy responses we’ve seen and will likely continue to see, have dampened the probabilities at least in the short term,” says Tom.

Yields on Caa-rated bonds are currently 9.7%⁶, above the 8.6% low set on May 11, 2011 and the 8.5% record-low set in January 2005 (Figure 4), resulting in the possibility for yields of Caa-rated bonds to fall further (which would result in rising prices for these securities).

Figure 4



Source: Barclays Capital as of September 26, 2012.

Long-term merits of high yield remain unchanged

Fundamentals remain strong

The fundamentals for high yield remain strong over the long term. “For one, high-yield companies have high cash balances to weather through some volatility,” says **Tristan Sones, Vice-President and Portfolio Manager**. “In comparison to historical data, they also have low default risk and low maturity risk as the majority of companies have already refinanced their higher coupon debt in this low-rate environment,” adds Tristan. This has pushed the “maturity wall” further out into the future (Figure 5). “Lastly, EBITA margins remain near a peak,

⁶ Source: Barclays Capital as of September 26, 2012.

which has supported relatively high and stable interest coverage for many high-yield companies,” adds Tristan (Figure 6). We believe this has reduced default risk as these companies are more able to service their debt.

Figure 5

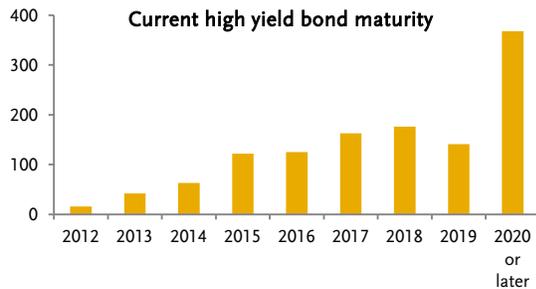
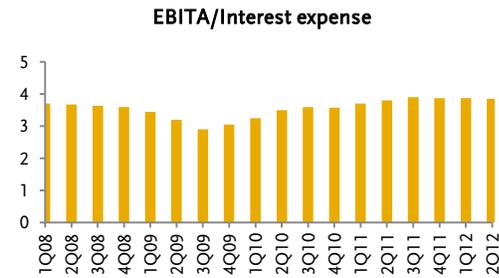


Figure 6



Sources: JP Morgan, High-Yield and Leveraged Loan Market Update, September 2012.

Diversification benefits and interest-rate insensitivity

High-yield bonds offer diversification benefits by offering low correlation with other asset classes, including investment-grade bonds (sovereign and corporate bonds) and equities. Given the technical backdrop and good corporate fundamentals, high-yield bonds can perform very well in a low-growth environment and are relatively insensitive to interest rate movements because of their wider spreads, which act as a buffer to rising rates. This is a unique advantage over investment-grade bonds. For this reason, we believe high-yield bonds are posed to outperform their investment-grade counterparts in a modestly rising interest rate environment, helping to protect an investors’ fixed income portfolio in such an environment. They have also historically performed well in a stable interest rate environment, which we believe will be the most likely scenario for at least the next number of years.

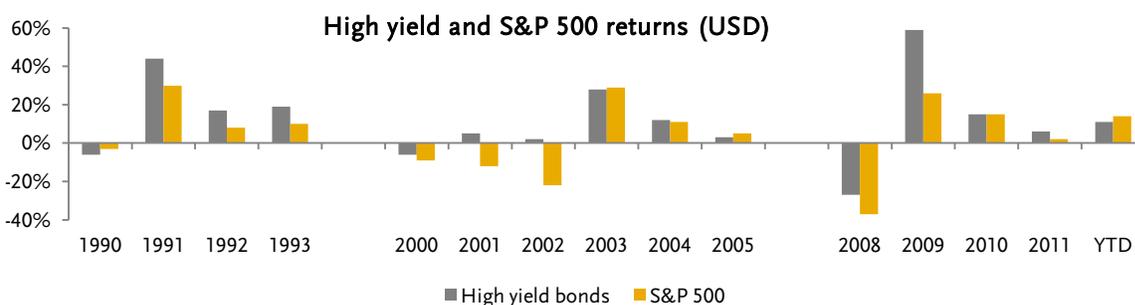
A substitute for equities

Historically speaking, high-yield bonds have outperformed equities in down markets, while equalling or even surpassing equity performance in the years leading out of a recession⁷ (Figure 7). This bodes well for high-yield bonds in the current environment. Whether a recession is approaching or we experience an extended period of sluggish growth, high-yield bonds can be an excellent investment in the context of a well-diversified portfolio.

⁷ Source: JP Morgan, High-Yield and Leveraged Loan Market Update, September 2012.



Figure 7



Sources: JP Morgan, High-Yield and Leveraged Loan Market Update, September 2012.

Equities require sustained economic growth and earnings growth, both of which cannot be assured in the current environment. Also, while past performance is not an indication of future performance, it is interesting to note that in the past 20 years, annual high-yield bond returns have only produced negative returns on four occasions.

Risks of investing in high-yield bonds

Despite the encouraging arguments in support of high-yield bonds stated above, there are risks to investing in high-yield bonds. The global economy remains in a precarious state and economic growth remains weaker than in prior post-recessionary periods at this stage in the economic cycle. While global macro concerns are expected to continue, the potential for spread widening is likely, especially if economic growth momentum slows and recessionary concerns rise. The upcoming fiscal cliff is another event that could widen spreads. A similar result could unfold if risk/reward opportunities start to favour other asset classes.

One short-term risk we are continuously monitoring is valuations. As stated above, we closely monitor Caa-rated yields and spreads to see if they overshoot and join their Ba and B-rated counterparts, which are currently expensive as a result of high investor demand. We also closely monitor new issuance to see if a higher-than-normal number of Caa-rated companies come to market, a risk that portends a market that is flooded with poor-quality companies. If this scenario were to play out, we would expect to trim some of our high-yield exposure.

Another short-term risk is the use of company proceeds from debt issuance. For the last few years, new issuance has been primarily focused on refinancing needs, with 62%³ year-to-date used for these purposes. The remaining proceeds have been used for general corporate purposes (20%⁴) and acquisition financing (15%⁴). If proceeds shift away from refinancing purposes to more shareholder-friendly activity, this would pose a risk to high-yield bond holders, at which time we would expect to trim our bond exposure.

³ Source: JP Morgan, High-Yield and Leveraged Loan Market Update, September 2012.

In summary

Despite strong absolute and relative returns for the high-yield fixed-income category, we feel that high-yield bonds have not run their course as they remain particularly attractive to many other fixed-income categories and asset classes, including equities.

Investors should consider an allocation to high-yield bonds as they offer strong risk-adjusted returns relative to equities due to their lower volatility. Longer-term, they have a number of attractive features, including high income, capital appreciation potential, diversification benefits (lower correlation with other asset classes) and for the next number of years, low default and maturity risk.

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