Script -
US High Yield Bonds
A Highly Sought-after Investment Vehicle

07/2015

Introduction of High Yield Bonds

As the name suggests, high yield bonds are bonds with higher yields, issued by companies with relatively lower credit ratings of less than "BBB-^", which is equivalent to non-investment grade. Yields offered by such bonds are considerably higher than those of government bonds because issuers have to make them more attractive to potential investors.

The last few decades have seen considerable growth of the high yield market, especially in Europe and the US. There are three characteristics of the US high yield bond market. First, it is the largest high yield market. Second, it makes up 80%* of the global high yield market. Third, it is well-diversified, covering a wide range of sectors.

The market now provides a positive environment for high yield bonds in four aspects:

1. Corporate balance sheets are healthy, indicating that strong high yield company fundamentals remain in place
2. The market provides investors of high yield bonds with a yield advantage over high-quality bonds, leading to an attractive income potential
3. Low defaults and moderate risk
4. Ample liquidity

(^ Source: Standard & Poor's as of 1 July 2015
*Source: JP Morgan; Bank of America Merrill Lynch; Bloomberg; Allianz Global Investors as of 31 December 2014)

Three Reasons to Invest in High Yield Bonds

First, it provides high income potential in a slow-growth world. Today's spreads give the high yield sector a significant yield advantage, not only over treasuries, but over other bonds as well.

Second, it offers solid risk-return profile over time. High yield bonds have a favourable risk-reward profile relative to other asset classes, providing equity-like potential returns with less volatility. In addition to higher regular payments than other asset classes, they may also offer capital appreciation potential.

Moreover, the high yield bond universe is well-diversified. This enables high yield bonds to actually help diversify rather than concentrate the bond portion of a portfolio, helping moderate overall risk.

Risks of High Yield Bonds

The main risks associated with high yield bonds are corporate default risks. In other words, the risks come from the companies that fail to make payments to the investors. However, US companies now find borrowing easier than before due to low interest rates in recent years, resulting in abundant cash at hand. These favourable factors have significantly lowered the defaults rates of US high yield bonds to around 1.7%*, which is much lower than the historical average.

On the other hand, market volatility should be carefully watched. A potential Interest rate hike from the US Federal Reserve and oil price drop may lead to a more volatile market. Hence investors should be aware of the market volatility when investing in the high yield market.

(*Source: Allianz Global Investors as of 30 April 2015.)