MUTUAL FUNDS

Returns earned on high-yield bonds are a function of the economic and market conditions prevailing during the investment period as well as the kinds of bonds held.

Fixed-Income Investing: An Objective Look at High-Yield Bond Funds

By Albert J. Fredman

High-yield (or "junk") bonds have received plenty of attention by the media, based largely on their sizzling returns in the 1980s, their infamous 1989-1990 plunge, and their subsequent rebound in 1991. But all the rhetoric may have left individuals with some misconceptions. Let's take an objective look at the high-yield market and the funds that invest there.

High-yield funds invest primarily in corporate debt rated below "investment grade"—that is, debt rated below Baa by Moody's or BBB by Standard and Poor's. As of April 1996, the Investment Company Institute database included 105 high-yield mutual funds with $64.5 billion in total assets. The vast majority impose sales loads, but a small group of no-loads also exist.

Huge quality differences are found within the high-yield arena. Bonds rated BB, B, CCC and CC by Standard & Poor's are speculative, with CC issues having the greatest probability of default. S&P's C-rated issues are not paying interest currently, while D-rated bonds are in default. High-yield funds hold varying credit-quality mixes, with some targeting lower quality issues than others.

Who Are the Issuers?

High-yield issuers are found in a wide range of industries and include larger, better-known companies such as Bally Entertainment, Bethlehem Steel, Kaufman & Broad, Levitz Furniture, MGM Grand, Revlon, Safeway, and Uniroyal Chemical as well as small, obscure outfits you've probably never heard of. Original issue junk bonds were popularized by Michael Milken at Drexel Burnham Lambert in the 1970s and account for most outstanding junk bonds today.

The high-yield arena separates into three basic categories:

- ***Fallen angels***: These downgraded issues were originally investment grade bonds of blue-chip companies. Virtually all junk bonds were of this type prior to 1977.
- ***Small emerging companies***: These nascent, often obscure firms lack the operating history and balance sheet strength to merit investment grade ratings. This group includes businesses wishing to refinance bank loans with a high-yield issue.
- ***Corporations involved in takeovers or buyouts***: This category consists of large firms seeking capital to finance an acquisition or a leveraged buyout—popular activities in the mid- to late-1980s.

Coupon Sizes

Junk bonds generally offer larger interest payments than high-grade securities. For example, an Inland Steel issue due to mature December 15, 2002, bears a 12.75% coupon. However, some high-yield issues don't currently pay income and aren't in default. They are deferred-interest securities such as zero-coupon bonds or payment-in-kind ("PIK") bonds. With the latter, interest is paid in additional PIK bonds or in cash, at the issuer's option, for a period that normally ranges from five to 10 years. These issues can appeal to corporations with near-term cash flow problems.

Morningstar provides a "coupon range" breakdown for the high-yield funds it tracks so you can see, for example, what percentage of a portfolio is in zero-coupon and PIK bonds (which are treated as zero-coupon bonds in their breakdown). Table 1 contains a recent breakdown for Morningstar's high-yield group. Note that the "not applicable" class includes issues making variable payments.

Why Invest in High-Yield Bonds?

Diversification into a unique asset class is the major benefit. High-yield bond returns tend to have relatively low correlation with returns of other bond groups during economic expan-

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Table 1.
High-Yield Fund
Coupon Allocations

Coupon Range	Portfolio Allocation (%)
0%, PIK	12.3
More than 0% to 11%	47.8
More than 11% to 13%	31.1
More than 13% to 14.5%	4.8
More than 14.5%	1.1
Not applicable	3.0

Source: Morningstar Mutual Funds, 2/16/96

sions as well as recessions.

- When the economy is expanding at a rapid clip, junk bond issuers generally do well. Conversely, if the Federal Reserve raises interest rates to cool the expansion, interest-sensitive long-term Treasuries are adversely impacted. But the high coupons of junk bonds can offset price declines due to rising rates because high-coupon issues are less sensitive to rate fluctuations than lower-coupon issues, all else equal.
- In a recession, long-term Treasuries do well when interest rates decline, and their prices rise, but the issuers of junk bonds can face tumultuous times.

The potential of higher total returns is a second benefit. Junk bonds have generally yielded three to five percentage points more than higher quality issues. You can calculate the yield spread between junk bonds and high-grade corporates or Treasuries at any time using numbers from the "Yield Comparisons" box in the Wall Street Journal's "Credit Markets" column. When lower-rated bonds are out-of-favor, as they were during the 1989-1990 debacle, the yield spread widens considerably. It reached about 10 percentage points toward year-end 1990. We many never again see a 10-percentage-point spread, however, as the high-yield market is a larger, higher quality, more liquid arena today than prior to the 1989-1990 collapse.

Table 2 shows annualized total returns for high-yield funds relative to A-rated corporate debt funds (which hold bonds of A quality or better) and U.S. Treasury funds, based on data from Lipper Analytical Services. The high-yield funds did comparatively well during the past three and five years because the favorable economic environment gave the sector a nice boost. Of course, this recent strong performance can be a harbinger of lower returns in the future, if economic conditions turn less favorable.

Table 2.
Annualized Total Returns of High-Yield and Other Bond Fund Categories

Fund Category	Total Return (%) for Performance Period*: 10 Years	5 Years	3 Years
General U.S. Treasury	8.10	8.68	5.72
A-Rated Corporate Debt	8.23	8.56	5.43
High Current Yield	9.01	13.94	8.61

**All periods end 3/29/96*

Source: Lipper Analytical Services

Junk Bonds vs. Stock

High-yield bonds resemble common stock because they are sensitive to changes in the issuer's earnings and balance sheet strength. An unexpectedly disastrous quarterly earnings report of a teetering corporation can send its debt spiraling downward. Conversely, unexpectedly good news can work wonders for a high-yield issue.

Because of their high-income component, portfolios of junk bonds tend to be less volatile than those of stocks. Junk bonds are also less risky than the stock of a given company because creditor claims have priority over those of owners. In addition, academic studies indicate that the long-run returns of junk bonds are less than those of stocks.

Table 3.
Total Return Components of
CS First Boston High-Yield Index

Year	Income (%)	Price Change (%)	Total Return (%)
1988	9.46	3.86	13.65
1989	12.01	–10.47	0.38
1990	11.68	–16.31	–6.38
1991	10.95	29.85	43.75
1992	9.92	6.15	16.66
1993	9.97	8.21	18.91
1994	9.71	–9.80	–0.97
1995	9.24	7.50	17.38

Source: CS First Boston Corporation.

Table 3 shows that the high income spun off by the bonds in the CS First Boston High-Yield Index exerts a stabilizing effect on returns. Of course this would be true for any diversified high-yield portfolio. The total return on a security includes both income and price changes. The losses of principal in 1989, 1990, and 1994 don't look quite so bad when the offset from high income is considered. You can take comfort from the fact that junk bonds have been tested by a severe bear market and rebounded strongly in 1991.

As with stock, you can profit by being a value investor. During recessions investors become increasingly skittish and you see a "flight to quality," as money moves from lower-grade to high-grade issues. This widens the yield spread between junk and higher-quality bonds. The greater this differential, the better the potential value for contrarians with patience and discipline. It's human nature to overreact to problems, which creates mispricings. When the economy is healthy (as it is at this writing) the yield spreads narrow, making the high-yield sector less attractive from a value perspective.

Sorting Out the Risks

Credit risk. A single bond faces plenty of company-specific risk. You need diversification and skilled management to make the high yields from junk bonds work for you. On average, winners outweigh losers by a comfortable margin in well-managed portfolios. The manager must do a lot of research in selecting the cream of the crop and monitoring positions. You want a manager who goes far beyond the bond rating because rating changes typically lag a change in the issuer's financial health. An astute individual can spot bonds that should have their ratings either raised or lowered, which can represent opportunities or bonds to be avoided or sold. In addition, non-rated bonds can constitute a big slice of a high-yield portfolio. Many issues are too small to justify the cost of an agency rating.

Are defaults a problem? Even though a portfolio is well-diversified and closely monitored, deteriorating credit quality could pose problems during a recession. Falling prices may outweigh the higher income earned. If, say, 10% of a fund's holdings default under extremely adverse conditions, the portfolio would obviously be hurt. However, if the income is sufficiently high to more than absorb the losses from default, performance could still be satisfactory. In addition, because holders of defaulted issues normally recoup at least 30% of their face value, losses from default are significantly less than what's indicated by the default rate.

Liquidity risk. Poor liquidity is another reason junk bonds offer higher yields than more highly-rated issues. Liquidity varies with economic and market conditions and the size of the issue. Many bonds are from small firms and have limited marketability. A significant proportion of these issues are non-rated. There is a wide spread between the dealer's bid and asked prices on illiquid issues. In a junk bond market debacle, spreads expand as prices fall.

Interest-rate risk. Rising rates are generally not as dominant a danger with high-yield portfolios as they are with high-grade bonds. The higher-quality junk bonds move in tandem with high-grade corporates to some degree, lower-quality issues are definitely more sensitive to company-specific factors, such as a change in the firm's cash flow. Those higher-quality funds with longer average maturities are most vulnerable to interest-rate risk.

Other perils. The high-yield market can experience sudden and sharp price swings arising from a variety of factors including a high-profile default or a rapid shift in sentiment. In addition, substantial redemptions by panicky fund investors put enormous pressure on the market, as we'll see. Callability is another consideration. During favorable times, high-coupon bonds may be called by their issuers, reducing the portfolio's income-generating potential.

The Cash Flow Factor

Investor money flowing into and out of high-yield portfolios can have a significant impact on the market. Mutual funds play a relatively larger role in the junk bond market than they do in, for example, the huge Treasury arena. Cash inflows for high-yield funds can boost the market for non-investment grade issues, whereas outflows hammer it down further. In turn, the resulting good (or bad) performance of the market draws more money in (or drives it out), reinforcing the trend.

Table 4 contains the yearly net new cash flow for the high-yield funds traced by the Investment Company Institute, which account for more than 95% of the universe. "Net new cash flow" equals net new sales (new sales minus redemptions) plus net exchanges. Also shown are the total net assets and number of funds by year. Note the large negative new cash flows during the 1989-1990 high-yield debacle. There was a modest setback during 1994, a year of rising interest rates.

So the market will be dealt a severe blow if individuals bail out en masse. Liquidity risk is exacerbated if large numbers of investors panic and redeem their fund shares, forcing managers to dump bonds at fire-sale prices, as in the chaotic 1989-1990 market. For example, the total assets of T. Rowe Price High Yield tumbled from $1.25 billion at year-end 1989 to $660 million a year later. Other high-yield funds experienced comparable declines. Junk bond funds sustained a negative 10.13% total return in 1990, according to Lipper Analytical Services.

Nevertheless, the sector will not dry up completely. As prices fall, the yield spread between junk bonds and Treasuries widens to the point that the former become screaming bargains, as in late 1990. The flip side of liquidity risk is the sharp rise in prices evidenced when sentiment shifts and the market rebounds, as in 1991 when the average high-yield fund returned 36.69%, according to Lipper. To be a successful high-yield investor you've got to be able to ride out the recessions, perhaps even adding to your

Table 4.
Historical Data on High-Yield Funds (dollars in millions)

Year	Net New Cash Flow ($)	Total Net Assets* ($)	Number of Funds*
1985	4,368.5	13,483.8	43
1986	9,618.1	24,591.6	57
1987	609.8	24,157.2	70
1988	3,208.6	33,425.2	102
1989	–2,875.5	28,492.4	104
1990	–5,054.5	18,868.0	106
1991	1,835.0	26,126.2	95
1992	4,606.1	34,258.6	89
1993	8,614.2	48,708.5	88
1994	–691.1	45,055.7	93
1995	8,141.6	59,715.9	99

Data as of year-end.

Source: Investment Company Institute

Table 5.
Selected Data on No-Load High-Yield Funds

Fund	Total Assets ($ mil)	Expense Ratio (%)	Volatility* (%)	Risk Index
Fidelity Capital & Income	2,330	0.96	5.6	1.2
Fidelity Spartan High Income	1,061	0.80	4.1	0.9
INVESCO Income—High Yield	331	1.00	4.7	1.0
Nicholas Income	159	0.60	3.6	0.8
Safeco High Yield Bond	40	1.01	4.0	0.9
T. Rowe Price High Yield	1,222	0.88	5.7	1.2
Value Line Aggressive Income	38	1.27	4.5	1.0
Vanguard High Yield Corporate	2,928	0.34	4.7	1.0

**Measured by standard deviation, the figure represents the amount by which most returns varied around the average.*

Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 15th edition, 1996, by AAII.

holdings when the junk/high-grade yield spread is particularly wide.

Analyzing a High-Yield Fund

Table 5 contains selected data for high-yield funds found in AAII's "The Individual Investor's Guide to Low-Load Mutual Funds" that have at least five years of total returns. These funds vary widely in size as indicated by the considerable range in total assets. Volatility of returns is measured by standard deviation (representing the range that most returns fell around the average) and the risk index expresses volatility as a number relative to the category average. High-yield bond funds are normally less volatile than stock funds. As a case in point, the Vanguard Index Trust 500, which targets the S&P 500, has a standard deviation of 8.2%, which is higher than that for any of the junk funds in Table 5.

Table 6 provides annual total returns and a five-year annualized return for the same group of funds. In addition to checking the standard deviation, you can get a good feel for past volatility by eyeing year-to-year returns, noting results in bad years such as 1990 and 1994. Management quality is more important for a junk fund than a higher-grade bond portfolio. Consider management tenure along with performance.

In addition to the performance numbers and other data, determine the annualized 30-day dividend yield of the portfolios you're considering by calling the fund companies. This yield is calculated with a formula mandated by the SEC. Higher yields may indicate lower-quality bonds and greater risk. The 30-day yield tends to overstate the yield of junk funds a bit because a modest percentage of the bonds could default.

Each high-yield fund is unique. Factors to consider when selecting one include the portfolio's normal quality mix within its high-yield core (usually amounting to at least 65% of assets). Junk bonds rated double-B perform more like higher-quality issues than those rated less than B. Thus, it's important to pay attention to portfolio quality, which may change. For instance, a manager may allocate more to lower-rated issues when the yield spread between junk and high-grade bonds widens and vice versa when it narrows. Also determine how the fund can invest the balance of its portfolio (the 35% that is not part of the core). The manager may hold high-grade corporates, Treasuries, foreign issues, convertible securities, and common stocks. Portfolio composition and a quality breakdown can be obtained from Morningstar or by calling the fund.

A higher-quality junk fund will have predominately double- and single-B-rated issues in its mix and hold only a limited number of issues rated less than single-B. Vanguard High-Yield Corporate falls into this group. For example, as of March 1, 1996, its net assets were allocated as follows: U.S. Treasuries, 15%; single-A corporate, 1%; triple-B, 3%; double-B, 30%; and single-B, 51%. No holdings were rated below single-B.

Conversely, a lower-quality junk fund may allocate nearly all of its assets to double-B or lower issues, including a significant proportion that are rated below single-B. Some funds may allocate a modest portion of their assets to issues in default, which may offer opportunity for substantial growth if their issuers emerge from bankruptcy. Some high-yield portfolios such as Fidelity Capital & Income also contain a moderate assortment of stocks because distressed companies often replace their bonds with stock when they restructure.

You need to determine not only how much credit risk the manager intends to assume, but how much has actually been assumed. The prospectus and shareholder reports should provide answers. In addition, the prospectuses of high-yield funds contain a percentage breakdown of total assets by letter rating. For non-rated debt, the document may provide a separate breakdown of what the management feels are the S&P-equivalent ratings.

Finally, interest-rate risk can be a factor in high-yield portfolios, so some junk bond funds tend to maintain a shorter average maturity. You can determine the average maturity and other recent statistics on funds by phoning the shareholder representatives.

Investment Considerations

Don't invest in a junk bond fund feeling totally confident that you will earn higher long-run returns than you might from a higher-quality bond fund. The results of academic studies on the performance of high-yield bonds are

Table 6.
Total Returns of High-Yield Bond Funds

Fund	Total Returns (%) 1995	1994	1993	1992	1991	1990	5-Year Annual
Fidelity Capital & Income	16.7	–4.6	24.8	28.0	29.8	–3.8	18.2
Fidelity Spartan High Income	17.7	3.1	21.8	21.4	34.3	—	19.2
INVESCO Income—High Yield	17.9	–4.9	15.6	14.5	23.4	–4.5	12.8
Nicholas Income	16.1	–0.1	12.9	10.3	23.0	–1.3	12.1
Safeco High Yield Bond	15.5	–2.2	16.9	13.8	24.2	–3.5	13.3
T. Rowe Price High Yield	15.7	–8.0	21.7	14.7	30.8	–10.9	14.2
Value Line Aggressive Income	20.0	–4.1	19.0	12.1	26.6	–3.6	14.2
Vanguard High Yield Corporate	19.1	–1.6	18.2	14.2	29.0	–5.8	15.3

Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 15th edition, 1996, by AAII.

mixed. There are no guarantees that a specific high-yield fund will outperform the average high-grade bond fund—even over periods of 10 years or longer. In addition, high-yield investors don't get a "free lunch" because these bonds are not consistently underpriced.

The returns earned on junk bonds are very much a function of the economic and market conditions prevailing during the period of measurement as well as the kinds of junk bonds held in the portfolio. High-yield investing demands skilled management to cherry pick the best issues and some high-yield funds have much better track records than others. Management is a far more important factor with high-yield funds than with government and high-grade corporate portfolios, which have returns that tend to cluster closer together.

Because of their volatility, dollar-cost averaging makes sense with high-yield funds, as it does with stock funds. In fact, when the portfolio is down during a high-yield bear market, you may even want to consider doubling up on your periodic investments, provided you have the time and patience to sit tight and wait for better times. In addition, dividend reinvestment works well with high-yield funds, as it also provides the opportunity to pick up shares at lower prices, thereby reducing your average cost per share.

Concluding Thoughts

How can high-yield funds fit into your asset mix? They make sense for a wide range of investors since they can offer some growth as well as income potential. Of course, they are not very tax efficient due to their higher income distributions. If the tax aspect concerns you, consider a tax-exempt high-yield fund such as T. Rowe Price Tax-Free High Yield, Scudder High Yield Tax-Free or Vanguard High-Yield Muni Bond. These funds don't assume as much credit risk as their corporate relatives because troubled municipalities aren't as prevalent.

High-yield investments are certainly not for everyone, but if they appeal to you, consider allocating 10% to 25% of your fixed-income holdings to the sector, based on factors such as your time horizon and risk tolerance. For most people, a high-yield fund makes a lot more sense than investing directly in the bonds.

With the exception of 1994, the high-yield sector has enjoyed robust returns since its 1991 rebound. While a modest investment in the sector makes sense, I would not recommend investing heavily now in view of this strong performance and the fact that high-yield bonds are not underpriced.