High-Yield Bond Funds: Plenty of Income, But How Much Added Risk?

By John Markese

Over the last five years, what funds have been virtually immune to stock market corrections, unfazed by rising interest rates, and have managed to produce high-income and double-digit returns, all with only the risk of government bonds?

Junk bond funds, of course.

Scratching your head over this investment paradox? High-yield corporate bond funds—the other term for 'junk bond' funds—have been extraordinary performers, particularly when adjusted for risk. Sounds topsy turvey, doesn't it?

As it turns out, it's just the basics of investing. One risky investment is risky, but put together 120 risky investments—in this case, higher-default-risk corporate bonds—and as long as the likelihood of many of them defaulting at the same time is small, the result is less risk for the portfolio of risky bonds than the risk of holding an individual low-risk bond. Such is the magic of diversification.

In addition, high-yield corporate bonds are less sensitive to interest rate changes than lower-yielding bonds. Why? Two reasons. First, the higher the interest payment on a bond, the less volatile that bond will be, with its price rising less when interest rates fall and its price falling less when interest rates rise. Second, high-yield bonds tend to act more like high-yielding common stock than bonds, because the interest payments can be uncertain, just as with dividends. Why, then, don't high-yield bonds move with the stock market? Because the information affecting the prospects of interest payments on bonds are unique to the firm or its industry and are not directly connected to the overall market.

But before you put high-yield bond funds into the perfect investment category, let's tick off some negatives. High yield means high income, and that means high taxes. Unless you hold a high-yield bond fund in a tax-sheltered account, be prepared for a big tax bite. Not all of the total return, though, will come from income; instead, some portion will come from capital gains if prices rise for the bonds held in the portfolio, and capital gains may be taxed at a lower rate than ordinary income for higher-bracket investors.

Are high-yield bond funds likely to have bad years? Of course. Their bad years are most likely to correspond to bad years in the economy. When the economy is in a slump, marginal firms often find it difficult to meet the high interest payments on their debt. In other words, the interest payments are high for a reason. There is a real risk that firms with lower-rated debt may be unable to cover interest payments as their revenues and income fall. Remember, the only way they could originally borrow—by selling bonds—was to promise high interest to compensate for the risk. Some high-yield bonds are fallen angels, in other words, debt of firms that originally was issued as higher-rated, but now because of adverse developments in the firm have a higher default risk; most high-yield debt, however, was originally issued as high-yield.

Within the high-yield segment of the bond market, it is difficult for individual investors to gain the expertise to analyze individual bonds, make selections, build a diversified portfolio, and monitor events that impact the individual issues. Good high-yield bond fund managers seek out bonds that are strengthening and more likely to see ratings upgrades rather than downgrades, as well as bonds that are more insulated from the economic cycle. In addition, with the resources of a mutual fund, diversification by issue can be much more extensive, reducing the impact of any one issue default on the portfolio.

But not all high-yield bond funds are alike, nor are all managers equally successful. A look at the important features of high-yield bond funds will illustrate the risks of investing in the area and will create a framework for evaluating high-yield bond funds.

Table 1 lists the high-yield bond funds covered in AAII's 1997 edition of "The Individual Investor's Guide to Low-Load

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Table 1.
High-Yield Bond Funds: Investment Characteristics

Fund (Ticker)	Annual Return 1996 (%)	Annual Return Tax-Adj. (%)	Past 3 Years Annual Return (%)	Past 3 Years Differ Categ. (%)	Past 5 Years Annual Return (%)	Past 5 Years Differ Categ. (%)	Bull* Market (%)	Bear** Market (%)	Yield (%)	Std. Dev. (%)	Avg. Mat. (yrs.)	Exp. Ratio (%)
Fidelity Capital & Income (FAGIX)	11.4	7.9	7.4	–1.3	14.6	2.5	26.7	–5.1	8.4	5.1	6.6	0.98
Fidelity Spartan High Income (SPHIX)	14.1	10.0	11.7	3.0	15.6	3.5	39.5	–3.2	8.2	4.1	6.4	0.80
INVESCO High Yield (FHYPX)	13.9	10.2	8.4	–0.3	11.1	–1.0	33.7	–6.2	8.4	5.1	7.8	0.99
Janus High Yield (JAHYX)	24.0	19.8	—	—	—	—	—	—	8.5	—	6.9	1.00
Legg Mason High Yield (LMHYX)	14.9	11.2	—	—	—	—	35.2	—	8.7	—	6.6	1.50
Nicholas Income (NCINX)	12.3	8.9	9.2	0.5	10.1	–2.0	32.4	–3.3	8.2	3.7	6.5	0.57
SAFECO High Yield (SAFHX)	10.3	6.8	7.6	–1.1	10.6	–1.5	26.7	–3.5	8.7	3.8	9.9	0.89
Strong High Yield Bond (STHYX)	26.8	22.4	—	—	—	—	—	—	8.8	—	6.5	0.95
T. Rowe Price High Yield (PRHYX)	11.5	7.8	5.9	–2.8	10.6	–1.5	28.4	–9.4	8.9	5.4	8.2	0.85
Value Line Aggressive Income (VAGIX)	19.7	15.7	11.2	2.5	12.9	0.8	42.6	–5.8	9.0	4.6	6.4	1.22
Vanguard Fixed-Inc High Yield (VWEHX)	9.5	6.0	8.6	–0.1	11.6	–0.5	33.5	–6.1	8.6	4.6	8.0	0.34
Corporate High-Yield Bond Average	**15.3**	**11.5**	**8.7**	**0.0**	**12.1**	**0.0**	**33.1**	**–5.3**	**8.6**	**4.5**	**7.2**	**0.92**
Vanguard Bd Index:Tot Bd (VBMFX)	**3.5**	**1.0**	**6.0**	**na**	**6.9**	**na**	**23.7**	**–5.1**	**6.5**	**4.5**	**8.8**	**0.20**

**July 1994 through December 1996.*
***February 1994 through June 1994.*

Mutual Funds" along with important statistics that characterize these funds. Table 2 describes the breakdown of investments for each fund by bond default rating and type of investment.

The 1996 total returns for the high-yield bond funds in Table 1 are certainly diverse. With a range of 9.5% for Vanguard to 26.8% for Strong, these funds must be doing some very different things in their portfolios. And some significant differences in return over longer periods is usually a flag for higher risk. The tax-adjusted total return demonstrates the ravages of taxes on these ordinary-income-generating machines; this tax-adjusted figure assumes the highest federal tax-bracket rate on income (39.6%), and a 28% capital gains tax rate. The tax effect is more pronounced for the lower-returning funds because the total return is almost entirely income. For the higher-return funds like Strong, the aftertax return is much closer to the before-tax return because most of the return is from capital gains, trading bonds in the portfolio.

The three-year and five-year returns—compound average annual returns for those periods—give a longer-term view of the performance of these funds. Again, the results fall all over the place, but cluster more for the five-year mark. Both Fidelity funds—Capital & Income and Spartan High Income—lead the pack of funds that were in existence for all five years. Three funds, including the 1996 return leader, Strong High-Yield Bond Fund, were not around even for the three-year statistic.

The difference from objective simply compares the fund's performance to its peer group—other funds with the same investment objective. Beating the direct competition by 2% or 3% on average each year over five years, when the average five-year return is 12.1%, is a significant accomplishment. But before you buy exceptional historical return, you should investigate how it was accomplished.

One question that should be asked of any fund is how is it likely to perform in bull and bear market environments. Bull markets overlap economic upturns, and it would be expected that high-yield bonds would do better than the average general bond fund in a bull market and about the same in a down market, where they are saved by their higher yields. The average corporate high-yield bond fund returned 33.1% in the bull market run and fell 5.3% in the bear market, compared to Vanguard's Total Bond Index, with a bull market performance of 23.7% and a bear market loss of 5.1%.

The final number contributing to any assessment of high-yield bond funds is yield, or current income to assets. These numbers often are the first 'grab' for investors, although aftertax total return is the ultimate measure of performance. And you can see why these funds are called high-yield—they average 8.6% compared to 6.5% for the Vanguard Total Bond Index. The Value Line Aggressive Income Fund lives up to its name by touching 9.0%.

But enough of the performance glitter, it's time to weigh the risks. An overall measure of volatility is standard deviation, and the higher the standard deviation number, the greater the total return volatility of the fund over the last three years. Corporate high-yield funds averaged a standard deviation of 4.5%, the same as the total bond index, and half of the standard deviation average for growth and income common stock funds. And while there are differences among these funds, none can be classified as extreme, again the return

Table 2.
High-Yield Bond Funds: Differences in Holdings

	Percentage of fund holdings in:							
Moody's:	Aaa–Baa	Ba	B	Caa, Ca, C		Stocks, Convert.		No. of
S&P:	AAA–BBB	BB	B	CCC, CC, C	Non-Rated	and Other	Cash	Bond Issues
Fidelity Capital & Income	6.4	6.6	30.7	8.5	3.8	23.5	20.5	123
Fidelity Spartan High Income	0.1	11.0	51.8	6.6	2.9	18.3	9.3	133
INVESCO High Yield	—	6.0	61.7	9.7	4.5	15.3	2.7	67
Janus High Yield	2.0	9.0	69.0	3.0	—	0.3	16.7	59
Legg Mason High Yield	—	5.1	67.7	3.7	14.0	4.7	4.7	105
Nicholas Income	0.6	24.2	49.4	—	6.6	10.2	9.0	47
Safeco High Yield	—	27.0	66.0	1.0	2.0	0.6	3.4	85
Strong High Yield Bond	0.5	23.7	61.1	3.6	—	4.2	6.9	65
T. Rowe Price High Yield	0.9	14.0	72.0	3.0	—	6.0	4.1	132
Value Line Aggressive Income Trust	—	8.3	47.3	5.1	13.6	17.5	8.3	53
Vanguard Fixed-Income High Yield	6.5	35.1	55.2	0.4	—	—	2.7	189

volatility dampened by the high income.

Another way to gain an insight on a bond fund is to look at maturity. All else equal, the longer the average maturity of the portfolio, the greater the risk.

Overall, the maturities of these funds fall in the high end of the intermediate-term range of three to 10 years. By comparison, the Vanguard Total Bond Index has an 8.8-year average maturity and only one of the high-yield funds—SAFECO, at 9.9 years—tops that. Since these bonds are less sensitive to interest rate changes already due to high yields, the average maturity is low enough to decrease interest sensitivity even more.

Table 2 takes another slant on risk, detailing the portfolio breakdown of each fund by default ratings and noting the number of issues held to help judge diversification. BBB (Standard & Poor's) and Baa (Moody's) default ratings are the lowest investment grade. Anything lower is considered to various degrees speculative and encompasses the general term 'junk.' Table 3 provides a brief explanation of the various Standard & Poor's ratings; Moody's provides similar interpretations for comparably rated issues.

These funds vary primarily in the distribution of bonds between the Ba and B categories, in the percentage of debt that is not rated, and the percentage invested in stocks, convertibles, and other. Overall, in the entire universe of high-yield bond funds, the distribution by ratings is close to 25% Ba-rated and 50% B-rated. T. Rowe Price, at 72% in B-rated bonds, is the most aggressive for this group and aggressive relative to the average for the universe of high-yield funds. But this higher-risk stance did not materialize into higher returns versus other funds.

As for diversification, Vanguard Fixed Income High Yield takes top honors, with 189 issues, probably more than necessary to diversify effectively and which may even add to portfolio expense. On the other end

Table 3.
Standard & Poor's Corporate Debt Rating Definitions

AAA: Highest debt rating assigned by Standard & Poor's. Capacity to pay interest and repay principal is extremely strong.

AA: Very strong capacity to pay interest and repay principal and differs from the higher-rated issues only in small degree.

A: Strong capacity to pay interest and repay principal, although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher-rated categories.

BBB: Regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher-rated categories.

BB, B, CCC, CC, C: Regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. BB indicates the lowest degree of speculation and C the highest degree of speculation. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.

is Nicholas Income with 47 issues, and if evenly distributed with a little over 2% in each, this should provide adequate diversification.

Some points to remember when investing in high-yield bond funds:

- High yield dampens return volatility.
- High-yield bond funds produce a big tax bite.
- Diversification reduces the risk of individual bond default.
- High-yield bonds do best when the economy is strong, and poorest when the economy is weak.
- High-yield bond funds can differ substantially in performance and risk.

High-risk bonds individually can be combined to form moderate risk portfolios. But high yields are high for a reason—risk. So don't be frightened away by the junk label, or blinded by the dazzling yields.