

ARE HIGH-YIELD BONDS A STRATEGIC OR TACTICAL ASSET?

In 2009, many risky asset classes experienced very strong rebounds. Yet, few did as well as high-yield bonds. Many investors captured these strong returns, while others wonder if such performances could remain strong in 2010 or if the trend is about to reverse itself. The most important question may lie in knowing whether high-yield bonds should always make up part of a portfolio, or whether they are a tactical trading asset class and need to be perceived as such.

OUTSTANDING RETURNS IN 2009 AS DEPRESSION FEARS ABATE

High-yield bonds acted as the poster child for the volatility-filled year just ended. Issued by highly leveraged companies, these assets have a history of seeing default levels - and investor losses - explode during recessions, only to see strong rebounds when the inevitable turn in the economy occurs. Overall, high-yield bonds declined about 27% in 2008, their worst showing in 20 years. At their all-time peak in mid-December 2008, spreads on such bonds reached 21.68% over risk-free Treasuries¹. Three weeks later, by January 2009, the bonds had already appreciated 11% from the trough! April then turned in the highest monthly return in history (+11.27%), and by the end of August, the year-to-date return exceeded 40%, beating the full-year record of 39.17% set in 1991. For the year, the Merrill Lynch Master II Index returned 57.51%(USD). As with most risky asset classes, the riskier the merrier in 2009, with distressed bonds (those trading at least 10% over treasuries) returning 96.79%. Needless to say, both are record performances.

MERRILL LYNCH MASTER II INDEX RETURNS FOR 2009 (USD)

Overall	57.51%
BB	45.21%
CCC	96.79%

Source: Bloomberg, Natcan

2010 OUTLOOK

Many are now wondering if high-yield bonds can provide investors with two consecutive years of outstanding performances. To answer this question, a good starting point would be to review the expectations imbedded in current prices. As of the start of 2010, the overall expected default rates were 3.95%, which is significantly higher than the long-term average, and is reflective of expectations for a subdued economic recovery. One can therefore assume that with a U.S. economy that has stabilized and begun a long healing cycle, well above average default expectations, and continued low interest rates, the asset category remains attractive.

HIGH YIELD BONDS: TACTICAL OR STRATEGIC INVESTMENT CATEGORY?

High-yield bonds exhibit many characteristics of equity investing. As such, issuer-specific (company) risk is of much greater importance at the time of the investment. This makes them diversifying and high-yielding assets, two attractive features rarely seen in combination. For the period ranging from January 1993 to June 2009, the correlation between high-yield bonds and U.S. large-cap stocks is lower than that of large- and small-cap stocks (0.59 versus 0.73). Additionally, their risk-adjusted returns compare, with Sharpe ratios of 0.52 and 0.54 respectively². Of course, substitutes exist.

One academic study has demonstrated that holding two thirds of a portfolio in investment-grade bonds and the remaining third split equally between large- and small-cap U.S. equities leads to equivalent results³. Such a combination may prove attractive by its apparent simplicity, but would definitely rely more on asset appreciation than current yield. Also, it would further eliminate the benefits of good portfolio management skills required for constructing a successful high-yield bond portfolio.

NATCAN MARKER

High-yield bonds performed admirably well in 2009. They appear to continue to be attractive, and could reward investors with strong risk-adjusted returns and high levels of cash flow in the coming months. When included in portfolios with a long-term orientation, they deserve a permanent and strategic allocation, which can be adjusted as a reflection of imbedded investor expectations.

Michael Quigley, CFA, CAIA
Senior vice-president, Distribution

FINANCIAL MARKETS

RETURNS AS AT JANUARY 15, 2009 (%)	MTD	QTD	YTD
S&P/TSX	-0.45	-0.45	-0.45
S&P 500	-0.15	-0.15	-0.15
S&P/TSX Small Cap	4.01	4.01	4.01
Russell 2000	-0.06	-0.06	-0.06
MSCI EAFE	0.95	0.95	0.95
MSCI World	0.40	0.40	0.40
DEX Universe Bond	0.97	0.97	0.97

RATES AS AT JANUARY 15, 2009	
CAD/USD	1.03
CAD/Euro	1.48
US Treasuries yield 10-yr/30-yr	3.68/4.58
GOC bond yield 10-yr/30-yr	3.49/4.05
Fed Fund Rate (target)	0.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

This publication is intended for your personal use. The information and opinions herein are provided for informational purposes only and are subject to change based on market and other conditions. The views expressed should therefore not be relied upon as the basis of your investment decisions. Past performance is not necessarily indicative of future performance. This document is not and should not be construed as a solicitation or offering of units of any fund or other security in any jurisdiction. No part of this publication may be reproduced in any manner without the prior written permission of Natcan Investment Management Inc. All market index returns presented in this commentary are expressed in Canadian dollar terms and were provided by Thomson Reuters, Standard & Poor's, a division of McGraw-Hill Companies Inc. and PC-Bond, a business unit of TSX Inc, unless otherwise specified.

¹ Lawrence C. Strauss. "Hewing to High-Quality Junk." An interview with J. Matthew Philo, Senior Managing Director, MacKay Shields, *Barron's Magazine*, May 11, 2009.

² Fridson Investment Advisors, October 9, 2009.

³ "Are You Too Late for the Junk-Bond Party?" *Wall Street Journal*, November 28, 2009.