Global high yield:

We believe it's still offering value

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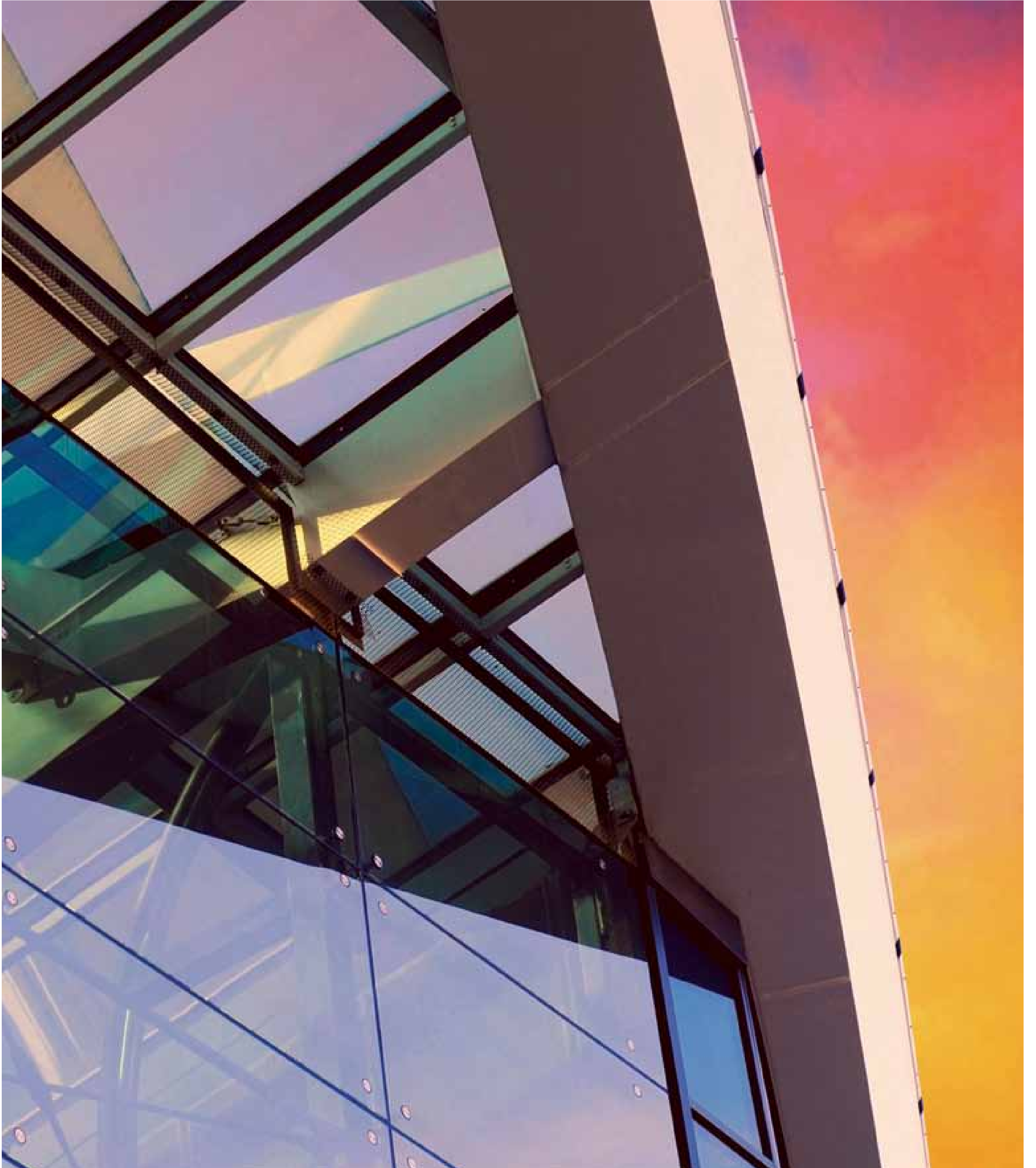

Global high yield: we believe it's still offering value

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Patrick Maldari is a Senior Portfolio Manager on the North American Fixed Income team. Patrick joined Aberdeen in May 2013 following the acquisition of Artio Global Management. From 2008–2013, Patrick held a similar role with Artio Global Management's Fixed Income Group. Prior to that, he spent twenty-two years at Merrill Lynch Investment Managers where he rose to become a Managing Director and Fixed Income Portfolio Manager. Patrick received his BS degree from Montclair State University and is a Chartered Financial Analyst. CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

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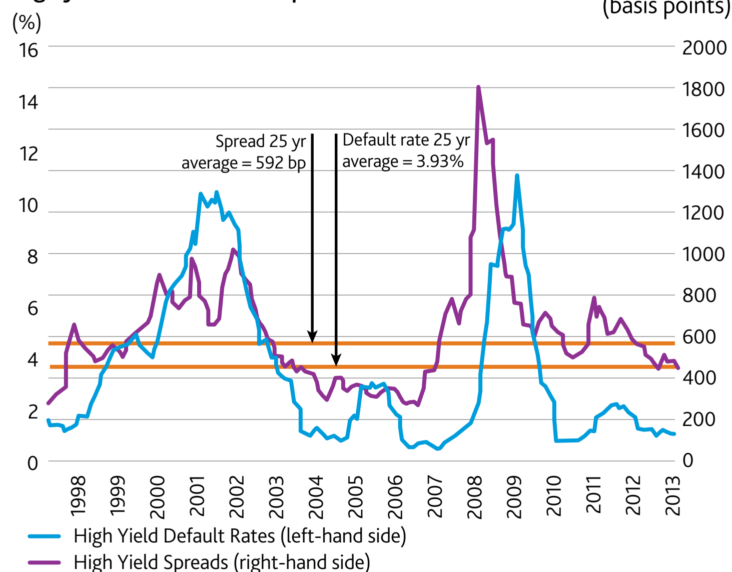
At Aberdeen Asset Management, we believe Global High Yield and U.S. High Yield markets are still offering value given the back drop of slow economic growth and credit trends that still appear favorable for investors. In this type of environment we expect default rates to remain low by historical standards which may continue to support valuations at current levels. For example over the last 25 years the spread differential between the high yield bond market and the trailing 12 month par weighted default rate has averaged 1.88% (5.92%-3.94%). Today that spread is over 200% wider than the historical average (4.63%-0.69%) and is currently trading at 3.94%.[1] What this means is that if we buy the market and experience the default rates priced into the market we believe we can achieve the historical results observed in the last example. Keep in mind default rates are "priced into the market" and given our experience, we believe we can effectively manage this default process and potentially deliver an above-market return. In addition we also have to factor in the yield curve and the intrinsic value of individual issuers which will also add to the value proposition.

High yield default rates vs spreads



Sources: JPMorgan, November 2013.
For illustrative purposes only.

Risks of investing in high yield securities

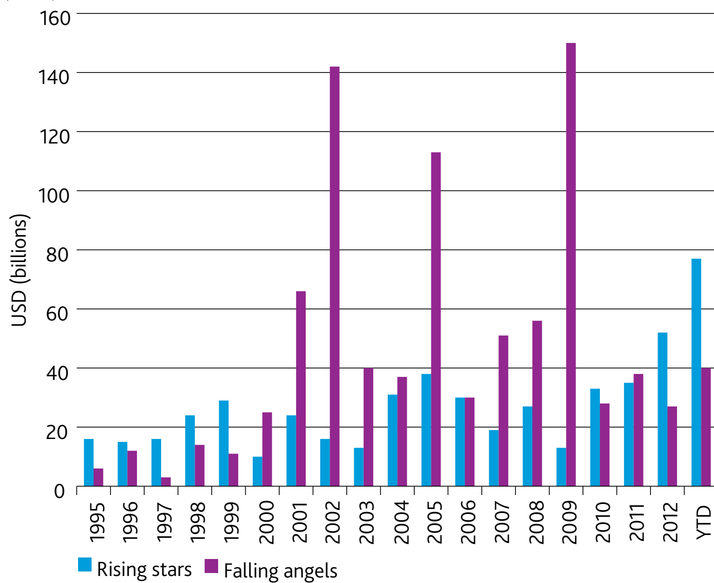
Investments in high yield bonds and other lower-rated securities present substantial risk of loss. Derivatives are speculative and present the risk of disproportionately increased losses and/or reduced gains when the financial asset or measure to which the derivative is linked changes in unexpected ways. Other potential risks include economic growth risks, inflation risks, liquidity, supply and external shocks. Additionally, high yield securities have higher transactions costs and are more likely to contain call provisions, which allow the issuer to call a bond for redemption before it matures.

[1] JP Morgan, November 2013

In addition to default cost and current valuations, there are several other factors to consider:

1. **Rising Stars versus Falling Angels**[2] – Over the last four years there has been considerable overall credit quality improvement as more companies have moved from the high yield sector to the investment-grade debt category (rising stars). In fact, $77 billion worth of high yield issuers have moved up in quality and are no longer in the high yield universe (see Chart 1 below). This has also helped to absorb some of the new issuance that has taken place so far in 2013 and, in fact, the net impact on the high yield market is at an historical high.[3]

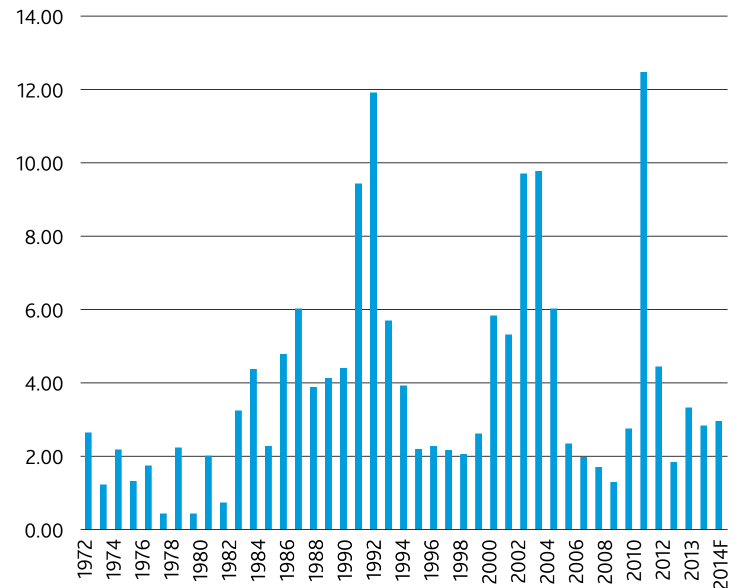
Chart 1: Rising star volumes outpacing fallen angels year-to-date
(YTD)



Source: JPMorgan, October 2013. For illustrative purposes only.

2. **Default rate cycle** – We believe that we are still in the "middle innings" of the default rate cycle. Typically after peaks in defaults such as the one that we witnessed in late 2009, the default rate may continue to trend lower and then bounce along at the lower end of the range. We feel that this cycle could be more prolonged than others due to the impact that the credit crisis has had on companies managing balance sheets. In our opinion, defaults potentially could stay below long-term averages (see Chart 2 below).

Chart 2: Global speculative-grade default rate
(%)

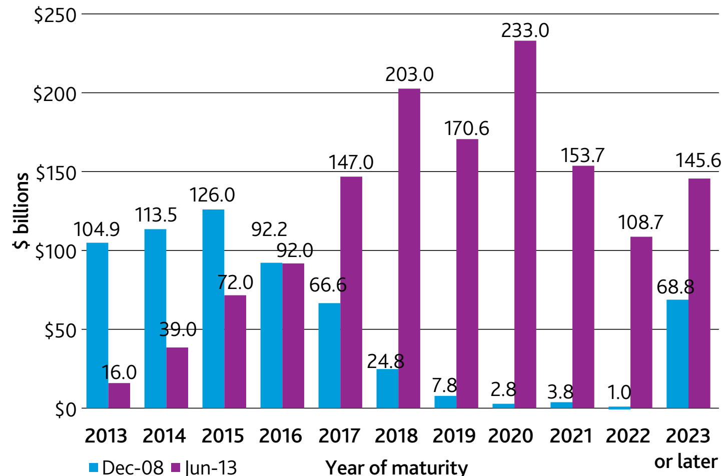


Source: JP Morgan, Moody's, October 2013. For illustrative purposes only. Forecasts and estimates are consensus opinion and are not based on potential performance. Actual events or results may differ materially.

[2] Falling angels refer to bonds that were once investment-grade but have since been downgraded to 'junk' status.
[3] JPMorgan, October 31, 2013

3. Maturities – The high yield asset class has witnessed a tremendous amount of issuance in the last few years ($1.441 trillion gross issuance globally since 2009)[4] as it appears that investors' search for income has allowed companies to tap into this demand. Without knowing the details, this might seem to be a negative; however, after further analysis, we believe that this huge issuance has actually been quite positive for the sector. First, the bulk of this issuance (60%) has been issued simply to refinance existing debt;[5] therefore, not a lot of net new debt has been issued. The next important factor to consider is: What has this issuance done to the maturity profile of the high yield market? As illustrated in Chart 3, maturities have been extended and, in our view, may give investors comfort that, in the near term, companies will not need to issue debt at an inopportune time.

Chart 3: U.S. High Yield Market Average Maturities
2008 vs. 2013



Sources: JP Morgan, June 2013
For illustrative purposes only.

4. High yield and rising rates – While we do not believe that rates will move up significantly in the near term, the high yield asset class has actually performed quite well in past periods when monetary policy has been unfriendly to bond markets (see chart 4 below). In fact only two periods have produced negative returns when analyzing the periods surrounding tightening cycles.[6] One other benefit for the high yield sector that normally is not discussed is what this higher rate period does to liabilities on the balance sheet. If rates were to rise materially, the present value of these liabilities for these high yield companies would drop sharply. We believe that this environment could potentially allow these high yield issuers to be able to use free cash flow to buy back debt at a discount and in effect de-leverage.

Chart 4: The Historical Impact of Rising Rates on the U.S. High Yield Market

Rising Rate Period 1: February 4, 1994-February 1, 1995

	Calendar-year returns (before, during, after full period)[7]			
	1993	**1994**	**1995**	**1996**
Year-end fed funds rate	3.00%	5.50%	5.63%	7.00%
Bank of America Merrill Lynch U.S. High Yield Master II Index	17.18%	-1.17%	19.91%	11.06%

Rising Rate Period 2: June 30, 1999 - May 16, 2000

	Calendar-year returns (before, during, after full period)			
	1998	**1999**	**2000**	**2001**
Year-end fed funds rate	5.00%	5.25%	6.25%	1.25%
Bank of America Merrill Lynch U.S. High Yield Master II Index	3.66%	1.57%	-3.79%	6.21%

Rising Rate Period 3: June 30, 2004 - June 29, 2006

	Calendar-year returns (before, during, after full period)				
	2003	**2004**	**2005**	**2006**	**2007**
Year-end fed funds rate	0.94%	2.25%	4.00%	5.38%	3.00%
Bank of America Merrill Lynch U.S. High Yield Master II Index	27.23%	10.76%	2.83%	11.64%	2.17%

Sources: U.S. Federal Reserve, Bank of America Merrill Lynch, June 2013
For illustrative purposes only.
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS.
The BofA Merrill Lynch US High Yield Master II Index tracks the performance of US dollar denominated below investment-grade corporate debt publicly issued in the US domestic market. Indices are unmanaged and are provided for comparison purposes only. No fees or expenses are reported. You cannot invest directly in an index.

[4] JPMorgan, June 2013
[5] Ibid.
[6] U.S. Federal Reserve, Bank of America Merrill Lynch, June 2013
[7] Before, during, after full period' refers to the accounting for data for the previous, actual and subsequent years reported.

5. **Excess spread over default cost[8]** – Valuation can be measured as excess spread over default cost, or the yield spread that remains after accounting for the cost of default and liquidity premium.[9] Based on this measure, we believe that there is value in the sector (see Chart 5 below). When making very conservative assumptions about recovery rates and a liquidity premium, we believe there is still "excess return" remaining.

Chart 5: Global High Yield Market
As of November 30, 2013

Global high yield option-adjusted spread (OAS)[10] over U.S. Treasuries (basis points or bps)	460
Aberdeen's default projection[11]	2.00%
Moody's recovery rate[12]	41%
Expected cost of default (bps)	-118
Liquidity premium (bps)	-50
Remaining excess spread over U.S. Treasuries after default and liquidity costs (bps)	292

Sources: Aberdeen Asset Management, Moody's, November 2013
For illustrative purposes only. Index represented for OAS: BAML Global High Yield Constrained Index.

6. **Income can potentially absorb volatility** – As seen in Chart 6 below, over any substantial period of time, the potential income that high yield securities can provide historically has enabled the sector to absorb a tremendous amount of volatility in price. Just look at past history when prices are about where they are today (Chart 6 shows five representative periods where the high yield market was priced similarly to current prices – approximately US$102). As one can note, yields were slightly higher (about 50-100 bps) during these time periods as the U.S. Treasury yield curve was higher; however, over any significant time frame, returns were positive except for the five year period that includes the fourth quarter of 2008.

Chart 6: Income/total return can absorb volatility over time

Date	6/21/1993	7/9/1997	12/11/2003	10/20/2010	5/3/2012
High Yield Price	$102.01	$102.09	$102.04	$102.06	$102.07
Total Return (%)	—	—	—	—	—
1 Year	4.26	11.32	11.22	2.73	14.2
3 Years	9.09	3.53	8.57	8.91	—
5 Years	10.82	0.93	-2.41	—	—
10 Years	6.87	6.2	—	—	—

*Returns for periods of more than one year are annualized.
Sources: Aberdeen Asset Management, Bloomberg, December 4, 2013. For illustrative purposes only.
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS.
The above is representative of the Bank of America ML U.S. High Yield Index and selected periods are provided for comparison to the current price (approximately US$100). The Bank of America ML U.S. High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Indices are unmanaged and are provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

[8] Excess spread is remaining net interest payments from the underlying assets of an asset-backed security, after all payables and expenses are covered.
[9] Liquidity premium is a premium that investors will demand when any given security can not be easily converted into cash, and converted at the fair market value.
[10] The option-adjusted spread (OAS) is a calculation of the relative value of a fixed income security containing an embedded option, such as a borrower's option to prepay a loan. A larger OAS implies a greater return for greater risks.
[11] Forecasts and estimates are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.
[12] Moody's estimates defaulted debt recovery rates using market bid prices observed roughly 30 days after the date of default. Recovery rates are measured as the ratio of price to par value.

Talk to your financial advisor today about how an allocation to high yield can potentially benefit your portfolio.

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The Bank of America Merrill Lynch Global High Yield Constrained Index contains all securities in the BofA Merrill Lynch Global High Yield Index but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%.

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