As we near the end of the credit cycle, the uncertain path of global economic growth coupled with weak crude oil prices present a challenging market, particularly in high-yield credit. Risk-averse investors may feel drawn to passive investment strategies in these challenging market environments. Yet most investors are unaware of the degree of volatility embedded within popular benchmarks, such as the Barclays U.S. Corporate High Yield Bond Index. Additionally, as high-yield spreads garner investor attention, many fail to appreciate the significant illiquidity in the space.

The volatility in U.S. high-yield corporate credit may have some investors wary of the merits of holding the segment in their portfolio. We believe tremendous investment opportunities should emerge from the asset class, but only to the extent one can properly navigate the risk factors driving the market. In our view, active managers focused on fundamentals can benefit investor portfolios while evading the potential pitfalls of high-yield credit. A selective approach to investment opportunities and the ability to avoid undue risk will be vital to successfully navigating the asset class in 2016.

**A Bifurcated Index: A Leading Risk**

The high-yield market is significantly bifurcated, as demonstrated by the difference in spreads between energy, metals and mining focused sectors and non-commodities related sectors in the high-yield index. Energy, metals and mining spreads are nearly twice spreads ex-energy, metals and mining. The index itself appears overly exposed to commodities’ risk, specifically relating to oil prices. Passive investors may not be aware of the unintended consequences associated with that risk.

**A DIVERGENCE IN HIGH-YIELD CREDIT SPREADS**

Spreads Widened in Aggregate, with Commodity-Related Sectors Leading the Charge

![Graph showing the divergence in high-yield credit spreads](source: Janus/Quantum Global. As of 3/15/16.)

Source: Janus/Quantum Global. As of 3/15/16.
Framed another way, the five highest yield-to-worst (YTW) sectors in the index have an average YTW of 16% – nearly twice the total index YTW. Given the degree of recent volatility and associated price movements in these commodities-related sectors, we believe these issuers are cheap for a reason, and in our view, many of the underlying bonds have rallied too far in the past few weeks. Energy, metals and mining sectors have retraced roughly 35% of the recent sell-off. We believe high demand and capital flow into high yield spurred the tightening more so than positive sentiment around higher oil prices.

**Increasing Illiquidity**

While commodities assumed the spotlight over the last several months, aggregate high-yield spreads widened considerably. This is due, in part, to the alarmingly low level of market liquidity in the space. The combination of post-financial crisis regulations sidelining banks from offering liquidity and volatile investor flows in high-yield credit have made it more difficult to transact. With the high-yield market approximately twice the size of pre-crisis levels, a lack of bank-supplied inventory requires buyers to interact directly with sellers and warrants greater compensation just to trade each issue. The liquidity premium is up dramatically from approximately 40 basis points pre-crisis to approximately 240 basis points today.
Fallen Angels: Risks, Rewards

Spread widening can also be attributed to amplified default risk. Historically low interest rates instigated a flurry of shareholder-friendly activity, balance sheet engineering and increased leverage in recent months. Many companies that issued bonds when commodity prices were high and debt was cheap are now struggling to meet their obligations, resulting in an increase in ratings downgrades. Cheap borrowing costs have actually enticed management teams across all sectors. In many cases, the increased debt has become problematic as global growth falls short of expectations and we near the end of the credit cycle. Of 175 downgrades during the fourth quarter of 2015, energy was responsible for nearly 30%, while 70% of downgrades occurred in non-energy related sectors. We expect the current pace of downgrades to continue.

An additional $43 billion in BBB-, $91 billion in BBB and $58 billion in BBB+ issuance is on negative watch at Standard & Poor’s, with the potential to be downgraded to high yield over the remainder of the year. We estimate one quarter of these prospective fallen angels are concentrated within energy. Should this shift occur, commodity-related sectors will account for a disproportionate weight in the high-yield index, bringing with it tremendous volatility for passive investors. Active high-yield managers, however, are presented with an opportunity. As investment grade managers are forced to sell fallen angels, high-yield managers with liquidity will likely be in prime position to selectively buy these higher-quality junk-rated names at a discount.

Investor Implications

We believe there is value in being defensively positioned, given the risk factors impacting the high-yield market. In our view, the downside risk inherent in exposure to the wrong securities within the benchmark outweighs the minimal upside. Security avoidance, until valuations make more sense, may be the most important tool that high-yield investors can deploy in today’s market environment. Our bottom-up, fundamental approach affords us the ability to avoid the riskiest segments of high-yield credit while taking advantage of strong risk-adjusted opportunities. Our investment style enables us to maintain liquidity in order to preserve buying power and avoid forced liquidity sales. We consider our unwavering focus on risk-adjusted returns and capital preservation essential to putting the interests of our clients first.

The composition of the benchmark may appear reasonable, given commodities-related industries have fallen from a high of 22% in 2014 to 15% in February 2016. However, a large shift of energy, metals and mining companies from investment-grade to high-yield would likely push the index weighting of commodities-related sectors back toward its peak, if not past it.
Past performance is no guarantee of future results.

Investing involves market risk. Investment return and value will fluctuate, and it is possible to lose money by investing.

High-yield/high-risk bonds, also known as "junk" bonds, involve a greater risk of default and price volatility than U.S. Government and other high quality bonds. High-yield/high-risk bonds can experience sudden and sharp price swings which will affect net asset value.

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