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Insight | February 2023

High yield

The power of carry

Sau Mui and Mark Miller

Sau Mui
High Yield Portfolio Manager

Main responsibilities

Sau is a portfolio manager on our global, short duration, and US high yield strategies.

Experience and qualifications

Prior to joining Aviva Investors, she was a portfolio manager for PPM America in Chicago where she managed the firm's core plus and credit-plus strategies on behalf of investors globally. Before assuming that role in 2019, Sau was a senior credit research analyst with the same firm, responsible for researching global investment grade and high yield Corporates in the financials sector. She also held positions as a credit research analyst with Harris Associates and as a high yield research associate with Putnam Investments.

Mark Miller
Investment Specialist, Credit

Main responsibilities

Mark is an investment specialist dedicated to active credit strategies. He works closely with the investment teams globally to articulate their investment process, portfolio positioning, and investment performance with clients and consultants.

Experience and qualifications

Mark joined the investment industry with Aviva Investors as part of their global graduate leadership programme. Having completed rotations within the legal team in London and the transformation team in Singapore, he joined the Investment Specialists team in 2020. Prior to joining Aviva Investors, Mark had worked in the financial services industry for over 15 years, with a focus on residential and commercial mortgages and insurance contracts.Economics and Behavioral Science. She is a CFA charterholder and a member of the CFA Society of Chicago.

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Key takeaways: Global high yield

After a tough 2022, investors may want to look afresh at global high yield:

Carry, provided by high coupons, currently constitutes a sizeable cushion to bear the impact of a material widening in yields and increase in the default rate.

Historically, the asset class has performed strongly in 12-month periods immediately after yields-to-worst hit eight per cent, the level they rose to in the second half of 2022.

Given improved credit quality in the asset class, we believe defaults will remain modest and should not exceed their four per cent long-term average, despite the weak short-term economic outlook.

Introduction

The doubling of yields in the global high-yield market over the past 12 months could open a window of opportunity for investors, as Sau Mui and Mark Miller explain.

The days of bondholders physically tearing off or clipping their bond coupons to collect interest payments are long gone, but the benefits of receiving regular coupon payments endure. Coupon income — also known as carry — is a crucial element in a bond's total return.

The power of carry is perhaps most evident in high yield, where relatively high coupon payments underpin the long-term performance of the asset class. We believe the combination of high coupons and currently outsized yields make a strong case for an allocation to global high yield in 2023.

Last year's aggressive rate hikes by central banks hit many markets hard, not least high yield: 2022 was the second-worst year on record for the asset class. However, the frequency and magnitude of interest-rate rises have transformed the yield environment.

The yield-to-worst — a measure of the lowest possible yield that can be received from owning a bond — of US high yield was 4.25 per cent entering 2022. It has since almost doubled, standing at just over eight per cent at the end of January.[1] The situation in Europe is even more remarkable: the yield-to-worst has more than doubled, from below three per cent to around 7.2 per cent, in part due to the benefits of currency hedging.[2]

1. Represented by the Bloomberg US Corporate High Yield Bond Index. Data as of January 24, 2023.
2. Represented by the Bloomberg Pan-European High Yield Index Hedged. Data as of January 24, 2023.

Cushioned against risks

High-yield investors face two main risks: losses from defaults and price falls caused by widening yields, the latter due to an increase in the risk-free rate or widening credit spreads as investors fret over the economic outlook and shun risk assets, or a combination of the two. Our analysis suggests today's yields of around eight per cent provide bondholders with more than adequate compensation for these risks, as we set out below.

Figure 1 details current total return breakeven rates in global high yield over a 12-month period. This shows how far default rates (assuming a 40 per cent recovery rate) and yields must move before total returns turn negative. If we assume a zero-default rate, we can see yields widen by almost 200 basis points (bps) from current levels before the asset class starts generating negative total returns.

Yields can widen by almost 200bps from current levels before the asset class starts generating negative total returns

Of course, the assumption of zero defaults is unrealistic, but it highlights the power of carry.

The high-yield market has experienced historically low default rates in the past 12 months. If one assumes default rates normalise over the next year, rising to their long-term average of four per cent, the breakeven yield movement drops to 125bps. Yields would have to increase from around eight per cent today to 9.25 per cent in the next 12 months before investors begin to receive negative total returns.

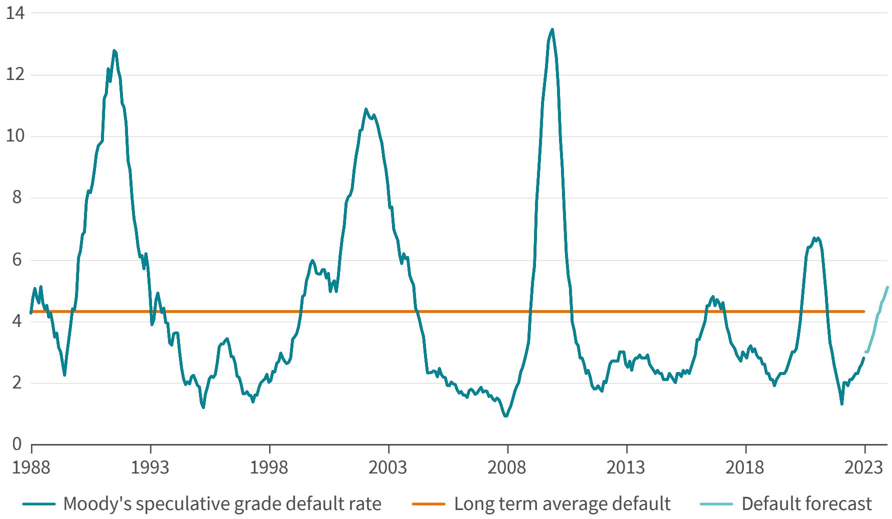
Although such a move is possible, the index's yield has only twice breached nine per cent in the past decade. In summary, the asset class's high carry provides a sizeable cushion against potential yield widening, even if defaults pick up from current levels.

Figure 1. **12-month total return breakeven analysis for all-maturities global high yield**

Global default rate	Global spreads													
	0	**25**	**50**	**75**	**100**	**125**	**150**	**175**	**200**	**225**	**250**	**275**	**300**	**325**
0.0	6.6	5.7	4.8	3.9	3.0	2.1	1.2	0.3	-0.7	-1.6	-2.5	-3.4	-4.3	-5.2
1.0	6.1	5.2	4.3	3.4	2.5	1.6	0.7	-0.2	-1.1	-2.0	-3.0	-3.9	-4.8	-5.7
2.0	5.7	4.7	3.8	2.9	2.0	1.1	0.2	-0.7	-1.6	-2.5	-3.4	-4.4	-5.3	-6.2
3.0	5.2	4.3	3.3	2.4	1.5	0.6	-0.3	-1.2	-2.1	-3.0	-3.9	-4.8	-5.8	-6.7
4.0	4.7	3.8	2.9	2.0	1.0	0.1	-0.8	-1.7	-2.6	-3.5	-4.4	-5.3	-6.2	-7.1
5.0	4.2	3.3	2.4	1.5	0.6	-0.4	-1.3	-2.2	-3.1	-4.0	-4.9	-5.8	-6.7	-7.6
6.0	3.7	2.8	1.9	1.0	0.1	-0.8	-1.8	-2.7	-3.6	-4.5	-5.4	-6.3	-7.2	-8.1
7.0	3.2	2.3	1.4	0.5	-0.4	-1.3	-2.2	-3.1	-4.1	-5.0	-5.9	-6.8	-7.7	-8.6
8.0	2.7	1.8	0.9	0.0	-0.9	-1.8	-2.7	-3.6	-4.5	-5.5	-6.4	-7.3	-8.2	-9.1
9.0	2.2	1.3	0.4	-0.5	-1.4	-2.3	-3.2	-4.1	-5.0	-5.9	-6.8	-7.8	-8.7	-9.6
10.0	1.8	0.9	-0.1	-1.0	-1.9	-2.8	-3.7	-4.6	-5.5	-6.4	-7.3	-8.2	-9.2	-10.1

Note: Based on the Bloomberg Global High Yield Excl CMBS & EMG 2% Cap Index.
Source: Aviva Investors. Data as of January 12, 2023.

Figure 2. **Long-term average default rate of global high yield (per cent)**



Source: Moody’s Investors Service. Data as of December 31, 2023.

The cushion provided by carry is even more pronounced for short-duration global high yield.[3] Figure 3 highlights the total return breakeven yield movement for the relevant index. Assuming no defaults, the index can withstand 250bps of yield widening before total returns turn negative. This higher figure is due to the shorter duration of the index and slightly higher yield relative to all-maturities high yield.

Again, assuming a more realistic three to four per cent default rate and 40 per cent recovery rate, the breakeven yield movement is 150-175bps. The index’s yield would need to increase from around eight per cent today to almost ten per cent before total returns turn negative over a 12-month period.

Once more, carry provides a sufficient cushion to absorb the adverse impacts of a realistic default rate and material yield widening from current levels.

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3. Represented by the Global High Yield Excl CMBS & EMG 2% Cap 1-5 Years Index.

Figure 3. **Breakevens for short-duration global high-yield**

Short duration global high yield spread movement

Short duration global high yield default rate	-50	-25	0	25	50	75	100	125	150	175	200	225	250	275
0.0	7.3	6.7	6.1	5.5	4.9	4.3	3.7	3.1	2.4	1.8	1.2	0.6	0.0	-0.6
1.0	6.8	6.2	5.6	5.0	4.4	3.8	3.1	2.5	1.9	1.3	0.7	0.1	-0.5	-1.1
2.0	6.3	5.7	5.1	4.5	3.9	3.2	2.6	2.0	1.4	0.8	0.2	-0.4	-1.0	-1.6
3.0	5.8	5.2	4.6	4.0	3.3	2.7	2.1	1.5	0.9	0.3	-0.3	-0.9	-1.5	-2.1
4.0	5.3	4.7	4.0	3.4	2.8	2.2	1.6	1.0	0.4	-0.2	-0.8	-1.4	-2.1	-2.7
5.0	4.8	4.1	3.5	2.9	2.3	1.7	1.1	0.5	-0.1	-0.7	-1.3	-2.0	-2.6	-3.2
6.0	4.2	3.6	3.0	2.4	1.8	1.2	0.6	0.0	-0.6	-1.3	-1.9	-2.5	-3.1	-3.7
7.0	3.7	3.1	2.5	1.9	1.3	0.7	0.1	-0.5	-1.2	-1.8	-2.4	-3.0	-3.6	-4.2
8.0	3.2	2.6	2.0	1.4	0.8	0.2	-0.4	-1.1	-1.7	-2.3	-2.9	-3.5	-4.1	-4.7
9.0	2.7	2.1	1.5	0.9	0.3	-0.4	-1.0	-1.6	-2.2	-2.8	-3.4	-4.0	-4.6	-5.2
10.0	2.2	1.6	1.0	0.4	-0.3	-0.9	-1.5	-2.1	-2.7	-3.3	-3.9	-4.5	-5.1	-5.7

Note: Based on the Global High Yield Excl CMBS & EMG 2% Cap 1-5 Years index.
Source: Aviva Investors. Data as of January 12, 2023.

Optimism on defaults

Our analysis hinges on default and recovery rate assumptions. Higher default rates — significantly above our four per cent projection and the long-term average — and lower recovery rates — significantly below the 40 per cent historical average — would challenge our argument.

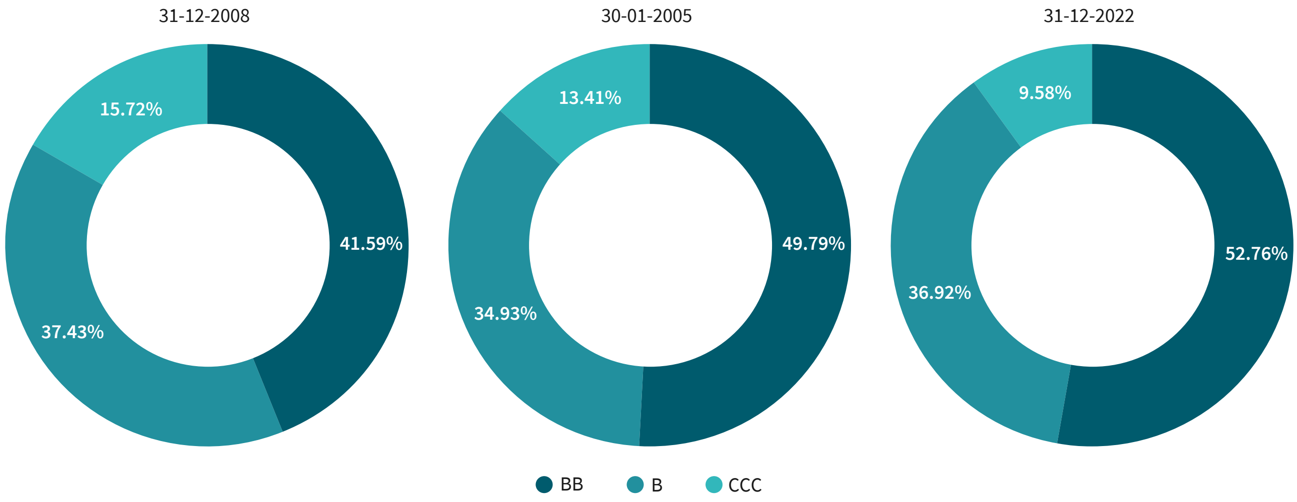
However, we see a strong case for defaults remaining benign. As we explored in our recent article *Focus on the fundamentals*, high-yield issuers largely entered 2023 from a position of strength. Additionally, there have been significant structural enhancements in the global high-yield market. These reinforce our view defaults will not climb to abnormally high levels anytime soon.

Furthermore, the convexity of the market has improved. With the global high-yield index price currently around US$89 and a larger share of secured bonds in the index today, as detailed below, loss-given-default — estimated losses from defaults — will be lower, assuming recovery rates remain in line with historical averages.

Structural improvements

Turning to the structural improvements referenced above, credit quality in the global high-yield universe is higher than in 2008 and 2015 (see Figure 4), two of the most significant drawdowns the high-yield market has experienced in the past two decades.

Figure 4. **Improving credit quality within global high yield**



Note: Index shown is Bloomberg Global High Yield xEM xCMBS 2% Issuer Cap Index.
Source: Aviva Investors, Bloomberg. Data as of December 31, 2022.

Higher-quality BB-rated bonds — where average default rates are typically around one per cent — now constitute over half of the universe. Meanwhile, the CCC-rated portion — where default rates are typically closer to 17 per cent — has fallen to less than ten per cent.

This improvement in credit quality is partly attributable to COVID-19, when many investment-grade issuers were downgraded to high-yield status in distressed market conditions. Around two-thirds of these fallen angels have since regained investment-grade ratings. However, many fundamentally robust, well-managed former investment-grade companies remain in the high-yield universe. This has increased the concentration of better-quality issuers.

Many issuers also took advantage of abundant liquidity in the years leading up to 2022 to strengthen balance sheets and extend maturities. Refinancing accounted for 60 per cent of high-yield issuance in 2021. This compares favourably to 2007, when over half of issuance funded riskier corporate activity.

60%

Of high-yield issuance was for refinancing in 2021

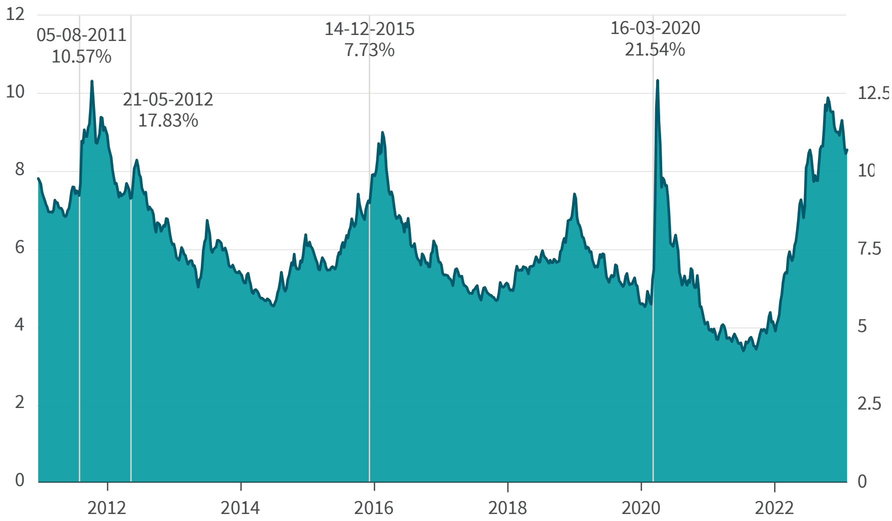
Regionally, the European market particularly reflects this shift. It has a greater concentration of BB-rated issuers than the US, which we expect to translate to lower defaults. Regional differences underline why a global approach can help drive outperformance.

As for recovery rates, secured bonds now constitute around one-quarter of the global high-yield market. The recovery rate for secured bonds is closer to 60 per cent rather than the typical 40 per cent recovery rate for regular high-yield bonds. The growth of this part of the market is positive for investors worried about loss-given-defaults.

Outsized returns after previous yield spikes

While past performance is never a guarantee of future results, it can be illustrative to review how global high yield performed in the wake of previous spikes when yields-to-worst hit eight per cent.

Figure 5. **Global high-yield 12-month returns after yields-to-worst hit eight per cent**



Source: Bloomberg. Data as of January 24, 2023.

As Figure 5 shows, over the 12-year period from December 2010 to December 2022, the asset class delivered double-digit 12-month trailing returns on three of the four occasions when yields-to-worst first hit eight per cent in a drawdown.[4] We believe it is reasonable to assume a similar pattern may occur again after last year's drawdown.

What makes the Aviva Investors Global High-Yield Bond Strategy different?

Relative resilience

Our active process recognises the asymmetric nature of the global high-yield market through an emphasis on downside protection. This is helped by a structural bias to higher quality (BB- and B-rated) issuers. We also have the flexibility to invest opportunistically in CCC-rated issuers when risk-reward profiles are attractive. Our conservative approach is reflected in an extremely low default rate since the strategy launched in September 2008.

A global approach

Our global approach eschews the regional sleeves favoured by many high-yield strategies. Our European and US-based portfolio managers work closely with our credit and ESG analysts to identify the most attractive issuers and best bonds within capital structures, irrespective of location.

We believe a global approach — rather than maintaining separate US and European portfolios and making a top-down call on their relative weighting within an overall portfolio — can help generate outperformance.

Having a holistic view, where all our managers run the entire portfolio together, balances risks across the whole book and helps unlock arbitrage opportunities from multi-currency issuance. Instead of making a pro-rata allocation between dollar-, euro- or sterling-denominated bonds when we have a positive view on a company, thereby diluting the alpha opportunity, we select the bond we believe offers the greatest value and allocate our full exposure to it.

Our ESG lens

Our investment process integrates company engagement and considers sustainability risk.

4. Based on the Bloomberg Global High Yield xEM xCMBS 2% Issuer Capped Index.

Key risks

Past performance is not a reliable guide to future performance.

Investment risk

The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Credit and interest rate risk

Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

Derivatives risk

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Investor in funds

Investments can be made in other funds; this could mean the overall charges are higher.

Illiquid securities risk

Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities). As a result, their prices can be volatile.

Sustainability risk

The level of sustainability risk may fluctuate depending on which investment opportunities the Investment Manager identifies. This means that the fund is exposed to Sustainability Risk which may impact the value of investments over the long term.

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391703 – 29/02/2024

Contact us

Aviva Investors
St Helen’s, 1 Undershaft
London EC3P 3DQ
+44 (0)20 7809 6000

www.avivainvestors.com