EFG

WHY DIVERSIFICATION IS ESSENTIAL IN HIGH YIELD

How diversifying in high yield leads to lower downside risk without reducing potential upside return

HIGH YIELD DIVERSIFICATION

High yield securities have a lower rating and involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Your Capital is at risk.

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- Many investors think that by increasing concentration you increase the potential upside of an investment. This is true to an extent in equity investing as the theoretical upside is unlimited.
- However, this does not apply to fixed income as the upside of any one bond is limited to the yield and the downside is 100%.
- This is even more true in high yield as the risk of a default is elevated.
- Below, through illustrative examples, we will show that **high yield concentration does not add any further upside return, increases downside risk and leads to much weaker liquidity.**
- However, **there is a sweet spot for diversification**, that is you want to have enough to manage downside risk, but not too much to dilute the best ideas in the portfolio.
- An effective way to achieve this optimal level of diversification is through a fund.

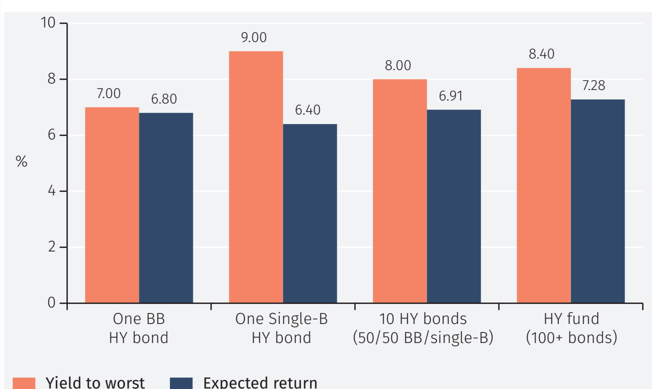
Why diversification is essential in high yield

Even if the high yield positions are only a small part of a wider portfolio, by using a diversified portfolio or fund the long term return will likely be higher than owning a concentrated number of high yield positions as the negative impact of defaults on the wider portfolio can be minimised without giving up yield.

Many investors own high yield bonds to maturity with the goal of clipping the coupon (i.e. buying the bond to maturity with the goal of achieving a pre-specified yield). However the dangerous assumption here is that the company won't get into trouble and have to restructure causing a permanent loss of capital. We like to say the strategy of **clipping coupons in high yield is like picking up coins in front of a steam roller**. Investors can still benefit from the attractive coupons in high yield, but one way to do this in a sophisticated manner is through the use of a fund that diversifies, takes an active approach, which aims to avoid problem companies, and pays out income.

- The upside of any bond is limited (capped) to the yield.
- The expected return of any bonds will be lower due to the expected probability of a default event.
- A fund can add extra yield through investing in subordinated CCC bonds where the higher risk of these bonds can be managed.
- **Bottom line: There is marginal to no difference in a concentrated bet within high yield versus a portfolio of high yield bonds.**

1. Potential upside - illustrative example from April 2023



Sources: Bloomberg and EFG calculations. Data as at 21 April 2023. The above data is built using ICE BAML high yield index averages. The chart is for illustration purposes only and there is no guarantee that the results shown will be achieved.

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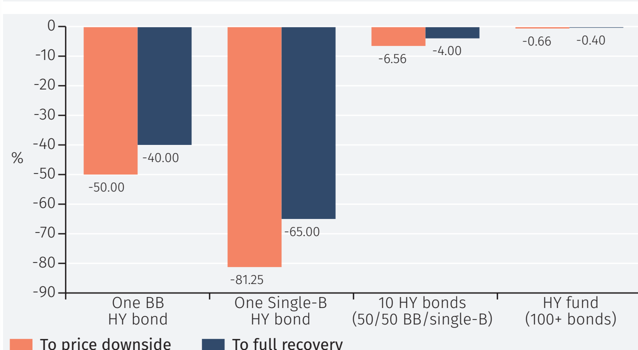
- The downside potential of any one bond is 100%.
- In reality, it will usually be less than 100% as the bond will have some level of recovery in a default.
- By diversifying the downside impact of any one bond becoming distressed or defaulting is minimised.
- **Bottom line: It is generally considered that there is a large benefit to diversification in high yield.**

2. Downside impact of a single name defaulting



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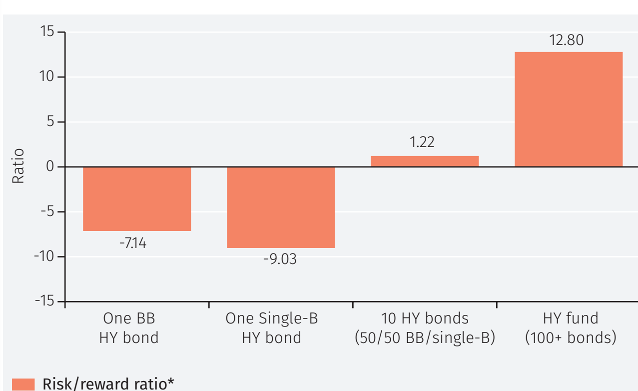
- As the upside is limited and the downside is significant, by diversifying across more positions the risk/reward profile becomes increasingly attractive.
- Expected returns remain within a tight range, but the risk significantly falls as you diversify with more bonds (less weight per bond).
- **Bottom line: With the improving risk/reward profile, when investing in high yield bonds it makes sense to invest in a diversified portfolio or fund of at least 100 bonds. As the minimum tradable amount of any bond purchase is usually greater than 100k, for an investor to build a diversified portfolio on their own they will typically need a portfolio of more than $10-15mn.**

3. Risk/reward (potential upside vs potential downside)



*The risk reward ratio shows how much is being risked for a potential upside. In the case of a bond, the upside is the yield on offer while the downside is the loss from a bond default. A score of -7.14 means that an investor is risking 7.14x the upside risk. i.e. for each 1% of potential upside risk they are taking, they are risking -7.14% of downside. Sources: Bloomberg and EFG calculations. Data as at 21 April 2023. The above data is built using ICE BAML high yield index averages. The chart is for illustration purposes only and there is no guarantee that the results shown will be achieved.

- In high yield, liquidity of any one bond varies over time due to a number of factors such as upcoming earnings and news events. By investing in high yield through a diversified portfolio or fund, short term liquidity needs are usually improved by spreading sales across a wider number of bonds.
- Typically, the lower the rating, the higher the cost to trade.
- If the bond becomes distressed the cost to trade can be as high as 5% and may take a number of weeks.
- **Bottom line: A diversified portfolio or fund reduces the liquidity cost given closer market access, ability to time sales and ability to spread sales across bonds.**

In summary, we think that **it is essential to diversify in high yield** as it a) increases risk/reward, b) minimises the negative impact of a default, c) allows for cheaper and faster market access/liquidity.
An effective way to diversify is through a fund.

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GLOSSARY

Coupon: The interest payments a bondholder receives until the bond matures.

Corporate bond: Debt instrument issued by a private corporation.

Credit/default risk: The risk of loss of principal when a borrower fails to repay a loan or meet a contractual obligation.

Credit spread: The difference in yield between a corporate bond and an equivalent maturity government bond. For example, if the 3-year US Treasury note is trading at a yield of 5% and a 3-year corporate bond is trading at a yield of 7%, the credit spread is 2%.

Expected returns: The amount of profit or loss anticipated from an investment.

High yield bond: Corporate bonds rated below BBB- or Baa3 by rating agencies. They typically offer higher coupons (and/or yields) vs government bonds or higher quality corporate bonds due to higher default risk.

Interest rate risk: When interest rates rise, the market value of fixed-income securities declines. Similarly, when interest rates decline, the market value of fixed-income securities increases.

Maturity: The number of years left until a bond repays its principal to investors.

Yield: There is marginal to no difference in a concentrated bets within high yield versus a portfolio of high yield bonds.

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