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4 things you should know about high-yield bonds

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The risks and rewards of high-yield bonds. And how interest rates, the energy sector and tariffs factor in.

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1. Higher risks require higher yields.

There are more risks in high-yield bonds compared with traditional fixed income. The asset class has navigated three significant default cycles over the past 30+ years. In each cycle, there was a meaningful decrease in high-yield bond prices, but they recovered alongside the economy, which proves the durability of the asset class to investors. High-yield bonds have demonstrated risk and return characteristics that fit between traditional fixed income and equities, and they can offer investors attractive risk-adjusted returns across the economic cycle.

2. Rising interest rates aren't necessarily bad for high-yield bonds.

Typically, interest rates rise in response to increased economic activity. This economic growth helps companies improve their financial health, which bodes well for high-yield bonds. Additionally, the excess spread (a measure of incremental yield over less-risky bonds) and moderate duration (a measure of interest-rate sensitivity) of the asset class act as a cushion against gradually rising interest rates. Generally speaking, a rising rate environment, short of a dramatic spike, can be good for high-yield bonds.

3. Energy is the largest high-yield sector, and it has three distinct subsectors.

Energy represents about 16% of the high-yield market.[1] In 2014, the price of oil was over $100 a barrel, and the energy sector peaked. Oil prices became weaker throughout 2015, and then they dropped to under $30 a barrel by early 2016. Prices stabilized later in that same year, but not before 47 of the 175 high-yield energy bond issuers went bankrupt.[2] It was the worst period for the energy sector since the 80s, and it reinforced the importance of investing in companies that can survive a cyclical downturn in commodity prices.

There are three separate and distinct energy subsectors: energy services, exploration and production (E&P) and pipelines, and each one has different

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characteristics and risks. **Energy services** is considered the riskiest subsector — it's very competitive with low barriers to entry and low profit margins. It includes offshore drillers, who depend on higher oil prices due to the higher cost nature of their business model. **E&P** companies are sensitive to commodity prices, but they can hedge their production, and they typically have high asset coverage due to their reserves in the ground. **Pipeline companies** are considered the least risky of the energy subsectors because of the fee-for-service structure in their business models, including regulated interstate pipelines — and they tend to have less commodity price exposure. Because there's a range of commodity price sensitivity of the underlying business models within the sector, a high-yield portfolio's energy risk depends on its mix of subsectors.

4. Tariffs have a limited effect on high-yield issuers.

While tariffs could affect certain sectors in the high-yield bond market more than others, the asset class is generally a U.S.-centric one. U.S.-centric business models will be less exposed to the direct economic impacts of tariffs compared with global business models and likely benefit from the recent tax reforms in the U.S. We think there could be more significant risks if financial conditions and monetary policy become more restrictive or if business and consumer sentiment deteriorates.

Bottom line

While high-yield bonds are riskier than other forms of fixed income, they've proven to be a durable asset class across the economic cycle. They can offer investors attractive risk-adjusted returns, even in a rising interest-rate environment.

[1] Source: Energy as a percentage of the high-yield market is measured by the ICE BofAML US HY Cash Pay Constrained Index as of 09/30/18.

[2] Source: Brian Lavin, Columbia Threadneedle Investments.

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