

CHRIS JOREL, CFA®
CLIENT PORTFOLIO
MANAGER

HIGH YIELD: FALLEN ANGELS AND THE IMPORTANCE OF CREDIT RESEARCH

This year, through September 30, \$168 billion of fallen angels entered the ICE BofA High Yield Index. How should investors think about this growing portion of the index?

Why do fallen angels matter?

For firms with skilled credit analysts, fallen angels, or former investment-grade (IG) bonds that have been downgraded, can represent an opportunity to purchase undervalued securities.

Data shows that, as a group, fallen angels have outperformed the broader high-yield (HY) asset class after entering the index. Exhibit 1 looks at the returns of fallen angels relative to original issue HY bonds over a series of four-year buckets: fallen angels outperform during each subperiod.

Exhibit 1: Comparative annualized returns (%) – corporate bonds

| | Fallen Angels | Original issues |
|-------------------|----------------------|------------------------|
| 1997–2001 | 9.17 | 2.49 |
| 2002–2006 | 11.63 | 9.18 |
| 2007–2011 | 8.40 | 6.98 |
| 2012–2016 | 11.63 | 6.70 |
| 2017–2020* | 7.12 | 4.63 |
| 1997–2020* | 9.70 | 6.04 |

*Through September 2020

Source: ICE Indices, LLC; Columbia Threadneedle Investments

Is this performance advantage enough to pursue fallen angels as an “asset class”?

Given their potential for outperformance, it may be tempting to isolate fallen angels and invest in them as a group. Bloomberg has helped facilitate this by creating a Fallen Angels Index. However, there are several issues when we examine this approach:

- **Roughly 24% of the index has less than two years to maturity**, likely offering little room for upside price movements.
- **The top 20 issuers account for roughly half** of the Fallen Angel Index’s market value. In addition, only about 20% of these largest names have been downgraded within the last couple of years. The largest name was downgraded to HY in 2015, for example, while another large issuer has bonds in the index that were downgraded in 2008. Both are technically fallen angels, but neither will be providing the boost indicated by historical data.
- **There is also significant industry concentration:** 28% of the index is in the energy sector and as you can see in the table below, more than 40% of this year’s fallen angels are in energy. According to the Columbia Threadneedle internal default forecast, energy is a sector that has had a high default rate and remains under continued pressure.

Exhibit 2: Fallen angels by sector – YTD

| Sector | Par (\$b) | Approximate U.S. High Yield Index weight* | % of YTD fallen angels |
|----------------|------------------|--|-------------------------------|
| Energy | 70,078 | 4.73% | 42.4% |
| Automotive | 35,771 | 2.12% | 21.6% |
| Consumer goods | 25,102 | 1.83% | 15.2% |
| Banking | 2,250 | 0.50% | 1.4% |
| Leisure | 2,070 | 0.47% | 1.3% |
| Basic industry | 5,170 | 0.45% | 3.1% |
| Retail | 5,822 | 0.44% | 3.5% |
| Travel | 4,000 | 0.43% | 2.4% |
| Real estate | 4,950 | 0.37% | 3.0% |
| Transportation | 4,000 | 0.35% | 2.4% |
| Utilities | 3,600 | 0.26% | 2.2% |
| Capital goods | 2,475 | 0.19% | 1.5% |

Source: ICE BofA US HY CP Constrained (JUCO) Index; Columbia Threadneedle Investments; as of September 30, 2020

While it is always tempting to look for free lunches in investing, the lack of diversification among fallen angels would seem to preclude using them in anything other than a diversified, comprehensive credit strategy.

Conclusion

While the distinction between investment grade and below investment grade isn't entirely arbitrary—there are rules and well-established guidelines—bond ratings are a continuum that lends itself to fundamental corporate credit research across the risk spectrum. While fallen angels may appear to offer quality investment opportunities within HY, according to Bank of America Merrill, they have defaulted at 2.6x the rate of original issue BB issuers and roughly in line with Bs. This reinforces the need for fundamental/bottom-up research on these names. Investors that understand credit dynamics can take advantage of downgrades, within HY or across the bond risk spectrum.

Past performance does not guarantee future results.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

The illustrations here are not intended to be representative of the performance of any particular investment. Such information has inherent limitations and may not be indicative of future results. It is important to keep in mind that no formula, model or tool can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them.

The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be appropriate for all investors. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that any forecasts are accurate. Information provided by third parties is deemed to be reliable but may be derived using methodologies or techniques that are proprietary or specific to the third-party source.

This document and the information contained herein is for informational purposes only and should not be considered a solicitation or offer of any investment product or service to any person in any jurisdiction where such solicitation or offer would be unlawful.

columbiathreadneedle.com



Columbia Threadneedle Investments (Columbia Threadneedle) is the global brand name of the Columbia and Threadneedle group of companies.

Columbia Management Investment Advisers, LLC is an investment adviser registered with the U.S. Securities and Exchange Commission.

© 2020 Columbia Management Investment Advisers, LLC. All rights reserved.

3326936

exp. 10/22