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# Separating Risk from Reality

Unless the global financial system implodes or panic engulfs the system, investments such as high-yield bonds and emerging market debt may be less risky than many believe.

We live in a world that emphasizes risk. That is true in general, but is especially so in the financial world. Since the financial crisis of 2008–2009, financial professionals have been acutely attuned to risk—and for good reason. Too many felt they were caught off-guard and unprepared by the near-implosion of five years ago. That in turn followed volatile periods from the Internet bubble of 1999 into early 2000, through the events of 9/11, and then a sharp market contraction until October 2002. After nearly 15 years of drama, it is hardly surprising that the financial world is primed for risk.

Hardly surprising, but a problem nonetheless. The heightened sensitivity to hidden risk muddies analysis, and can potentially lead to mispricing of assets and hence, less-than-optimal investment decisions.

The current yields and attitudes towards both high-yield ("junk") bonds and emerging market debt are prime examples. Both are seen as risky assets with both known and unknown pitfalls. The International Monetary Fund (IMF) in April warned that many investors in emerging markets bonds may be unaware and unprepared for a combination of slowing growth and rising rates that could impact many portfolios negatively, especially given the surge of money into emerging markets bonds since 2008. There is now $76 billion in retail mutual funds focused on the space, up from $12 billion before 2008. The IMF also emphasized the increase in issuance, with $300 billion in emerging market corporate

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bonds coming to market last year alone. That is frequently interpreted as a sign that the market is—to use a common cliché—"getting frothy."

But is it? It is too easy these days to make the argument for bubbles, bubbles everywhere, and for overpriced assets at every turn. In light of a volatile 15 years, where the downs have felt more severe than the ups, such arguments are intuitive and have emotional resonance. That does not, however, make them correct.

## A Matter of Perceptions

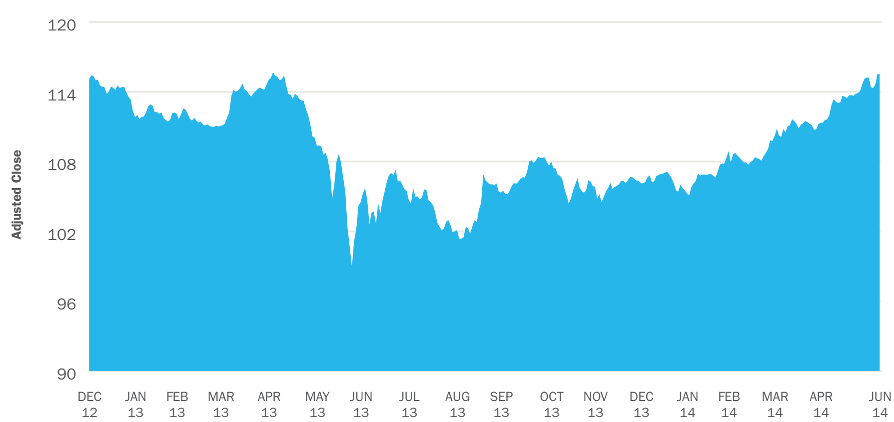
Both high-yield ("junk") bonds and emerging market debt are perceived as inherently more risky than many more vanilla investment options. There are at least two types of risk: greater chance of loss (more downside) and greater volatility. Compared with, say, blue-chip large cap companies such as IBM or Walmart, or with investment-grade bond portfolios, or with U.S. Treasuries, junk and emerging market debt are understood as riskier and hence provide higher returns to lenders in the form of higher interest rates. They are also susceptible to price swings that can be intense.

Last June of 2013, when then chairman of the Federal Reserve (Fed) Ben Bernanke hinted that the Fed would begin to pare its bond buying program, emerging market debt sold off very hard, with prices dropping in many instances by more than 10% in the space of weeks. The reason was not a sudden change in the fundamentals of Turkish or Brazilian bonds, but rather the market perception that those bonds had seen strong inflows based largely on the presence of so much money in the global system as a result of Fed policies. The concern was that when the Fed began to trim the easy, easy money, those bonds would see both outflows and a drop in demand.

And yet, a year later, the Fed is aggressively trimming its bond buying program, having reduced its monthly purchases almost in half and on a glide path to reducing them entirely by year-end. Emerging market bonds, meanwhile, have recovered all of what they lost in June 2013 and yields are actually lower after the recent run since May (Figure 1). The market interpretation that these assets were simply a derivative of a Fed bubble was wrong.

Of course, it may only be temporarily wrong. Another shock to the global system could well prove the risk interpretation correct. The ever-present concern that all financial assets are still being artificially boosted by central bank liquidity won't fully dissipate until central banks tighten globally. With the actions by the European Central Bank (ECB) announced on June 5, however, we are nowhere near an end to these policies. In fact, the ECB, led by its president Mario Draghi, is now embarking on its own policies of quantitative easing just as the U.S. Fed is pulling back.

**Figure 1:**
**iShares J.P. Morgan USD Emerging Markets Bond ETF**



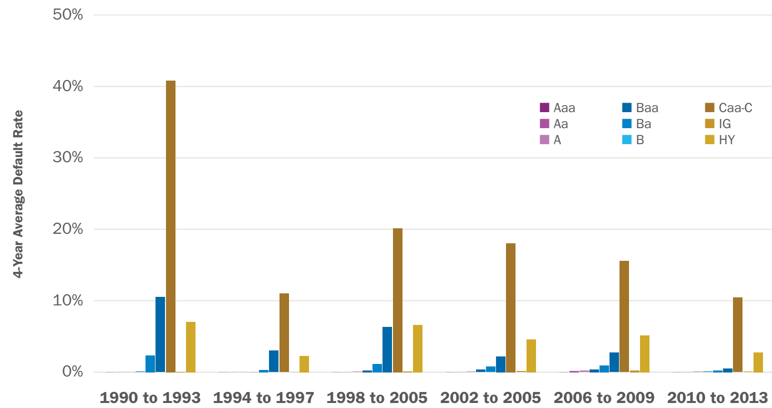

Source: Yahoo Finance

Combined with the easy money policies of Shinzo Abe in Japan, we are in for a considerable period of significant liquidity. And then there is the surfeit of liquidity in sovereign wealth funds—well in excess of $5 trillion—and in corporate balance sheets which add trillions more. If you are waiting for a liquidity squeeze, you might be waiting for a long, long time.

The market price for high-yield and emerging market debt suggests that the prices being paid and the rates being offered for these instruments are not pricing in much risk. Low-rated bonds still bear the moniker "junk" from a time in the 1970s and 1980s when low-rated or questionable businesses simply could not get financing from banks at any price and had to pay much more generously to investors to compensate them for the risk.

Today, however, many, many low-rated bonds have only a slightly higher level of actual risk—as defined by default risk—than bonds considered "safe." Over the past three years, the default rate for bonds rated "junk" (i.e. those rated 'BB' or lower by Standard & Poor's, or 'Ba' or lower by Moody's) has been only a few percentage points worse than those rated investment-grade. Except for a spike in 2009, in fact, when low-rated bonds had a default rate of more than 8%, so-called "junk" bonds have had a default rate of less than 5%, and in the past few years less than 2.5%. The very lowest ratings, C and less, have had higher default rates, as to be expected. But bonds with a B rating have had default rates of less than 1.5% since 2003 (Figure 2).

**Figure 2:**
**Annual issuer-weighted corporate default rates by letter rating, 1990–2013**

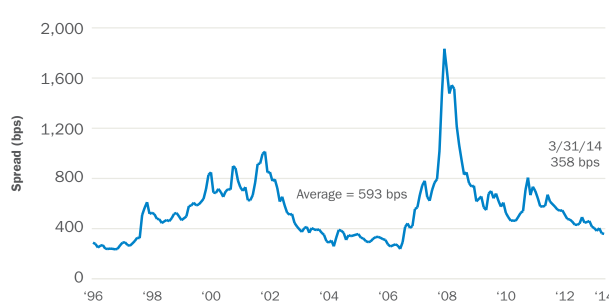



Source: Strategas Research Partners

The picture is similar with emerging market bonds. Yet both emerging market and high-yield still trade at a significant premium to treasuries and investment-grade corporate bonds. Yes, those spreads have been compressing, and as more money has poured into these bonds in the past few years, they have compressed further (Figure 3 and Figure 4).

**Figure 3:**
**U.S. Investment-Grade Corporate Rates vs. Treasuries**


**Figure 4:**
**U.S. High-Yield Corporate Rates vs. Treasuries**




Source: Strategas Research Partners

Note: Rates are based on an Option-Adjusted Spread (OAS). OAS is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options. The OAS we are using measures the difference between interest rates for similar-maturity investment-grade corporate bonds and treasury bonds. The OAS on investment-grade corporate debt is viewed as a gauge of credit spreads. (A higher OAS implies greater anticipated default risk and therefore a higher risk premium. A lower OAS implies a greater availability of credit and more operational flexibility.)

The modest spread between high-grade bonds on the one hand and emerging markets and high-yield on the other is itself taken as an indication that investors may be investing too much in higher-risk assets. As more money has poured into funds that invest in those assets, prices have risen and yields have therefore dropped. The question for many now is whether those yields are appropriate given the nature of the risk.

### Staking the Middle Ground Between Risk and Return

There is, of course, no easy answer here. There is the very low default rate, save for the worst credit quality. There is the reality that many emerging market bonds, whether corporate or sovereign, are issued by countries and companies that are risky only because countries such as Mexico, Turkey, and South Korea were once considered riskier. And there is the fact that we live in a world suffused with capital with low inflation, which means that legitimate entities do not need to pay exorbitant rates.

If you believe that we remain in an artificial lull of easy money provided by central banks, that rates will rise sharply soon enough, that markets will roil, and that there is some new crises just beyond the advent horizon, then yes, emerging market and high-yield debt will suffer disproportionately. If not, however, these assets may not have significantly greater downside than U.S. Treasuries and investment-grade corporate debt even as they carry a risk premium that assumes they are. Until the investing world stops fixating on risk and focuses more prominently on return, that will remain the case. ■

**Advisor Take-Away:**

Heightened awareness of risks and fear of bubbles have made it more challenging for advisors to evaluate portfolio risk. Given unprecedented levels of liquidity, and both the Fed and European Central Bank adopting an accommodative stance, high-yield bonds and emerging market debt may present less downside than typically perceived. While potentially more volatile, they have presented less default risk in the past few years. For those who expect a major correction or systemic crisis, investments such as these are indeed vulnerable; absent that, they may be less risky and more attractive. As always, it is critical to evaluate client portfolios and revisit previous notions of risk—whether market risk, credit risk, or idiosyncratic risk—within the context of ever-changing market dynamics.



High-Yield Bonds ("Junk" Bonds) are high paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds, and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment-grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below 'BBB' from S&P, and below 'Baa' from Moody's. Bonds with ratings at or above these levels are considered investment-grade. Credit ratings can be as low as 'D' (currently in default), and most bonds with 'C' ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Emerging market debt is a term used to encompass bonds issued by less developed countries.

The International Monetary Fund (IMF) is an international organization that was initiated in 1944 at the Bretton Woods Conference and formally created in 1945 by 29 member countries. The IMF's stated goal was to assist in the reconstruction of the world's international payment system post-World War II.

United States Treasury security is a government debt issued by the United States Department of the Treasury through the Bureau of the Public Debt. Treasury securities are the debt financing instruments of the United States federal government, and they are often referred to simply as Treasuries.

A sovereign wealth fund (SWF) is a state-owned investment fund investing in real and financial assets such as stocks, bonds, real estate, precious metals, or in alternative investments such as private equity fund or hedge funds. Sovereign wealth funds invest globally.

At A Premium refers to the sale of an asset or item at a price significantly above the original purchase price due to high demand, rather than appreciation. At a premium can indicate its increased price and limited supply. Changes in market interest rates, superior performance and limited supply, are examples of factors that can cause an investment to be in high demand and to trade at a premium.