High Yield Bonds — The Search for Yield

In today's low interest rate environment, investors continue to search for higher yields and many are considering high yield bonds. We thought it would be appropriate to explore what high yield bonds are, how they compare to other products, what risks are involved and what makes them attractive.

High Yield Bonds Defined

Let's begin with what high yield bonds are. Bonds can be divided into two categories, investment grade and non-investment grade (high yield.) Both pay interest income and have maturity dates, but where they differ is in their credit ratings. Credit ratings are an opinion of a recognized rating agency of the general credit worthiness of an issuer to meet its interest and principle payment obligations. The most commonly referenced agencies include Standard & Poor's (S&P), Dominion Bond Rating Service (DBRS) and Moody's. (see Table 1).

To put some perspective on the ratings, Government of Canada bonds are rated **AAA** while provincial bonds typically range from AA to A.

Bond Rating Scales

Rating	DBRS I S&P	Moody's	
Highest quality	AAA	Aaa	Investment Grade Quality
High quality	AA	Aa	
Upper medium quality	A	A	
Medium grade	BBB	Baa	
Somewhat speculative	BB	Ba	Non-Investment Grade (High Yield)
Low grade, speculative	B	B	
Low grade, default possible	CCC	Caa	
Low grade, partial recovery possible	CC	Ca	
Default, recovery unlikely	C	C	

Source: Dominion Bond Rating Service Ltd., Standard & Poor's, Moody's Investors Service

So why the attraction to high yield? For one, high yield bonds pay higher income to compensate for the added risk assumed. This yield premium (credit spread) is the difference between the yield of a high yield bond and a Federal Government Bond. In the U.S. the credit spread has typically ranged between 300-400 basis points (3-4%) but is currently much wider; reflecting perceived risks in the credit markets. In Canada, historical spreads have averaged about 200 basis points over the "Canada's," but like in the US, current spreads have also widened reflecting concerns over the potential for increased issuer defaults.

Income and Growth potential?

As above, the wider than normal yield spreads are partially due to the potential for increased defaults. It is likely however that credit spreads will regress back to a more normal state as the economy emerges from recession. Tightening credit spreads could potentially result in capital gains in high yield bonds...

A bond may appreciate as a result of one or a combination of factors including; positive events in the economy and industry, improving fundamentals at the issuing company, market-related events and rating upgrades. This increased price appreciation potential is often due to changes in default risk.... High yield bonds have lower credit ratings because there is a possibility that the bond could default on its debt obligation. High yield bonds are more influenced by *company specific news* as well as events which could possibly affect its ability to repay its debt."

Risks

Risks include credit risk, default risk, economic and interest rate risk, company specific and industry-related risks. Also consider liquidity – high yield bonds can at times be less liquid than other *investment grade* bonds, depending on market conditions and/or the issuer of the debt.