Memo to: Oaktree High Yield Bond Clients

From: Howard Marks and Sheldon Stone

Re: High Yield Bonds Today

Clients often ask for our views on the high yield bond market: "Do we think prices are too high?" "Are yields too low?" "What returns can we expect next year?" We caution them that it's nearly impossible to accurately predict these things, and anyone who makes such forecasts is unlikely to be right.

These days the question is primarily whether high yield bonds are in a bubble and poised to collapse, given last year's strong performance and today's historically low yields. We don't think high yield bonds are any more vulnerable to rising rates than other fixed income instruments. We don't downplay the risk in the market nowadays and the fact that bond prices are quite high. **However, the situation isn't unique to high yield bonds; rather, it is true of virtually all bonds and reflects the concerted effort on the part of central banks around the world to hold down interest rates.** Yields are at historic lows and prices are unusually high all across the fixed income spectrum.

However, **two factors argue strongly that high yield bonds are less vulnerable to rising interest rates than other fixed income sectors**:

- A high yield bond of a given maturity has a shorter duration than an investment grade rated bond of the same maturity, since duration is a measure of the weighted average time to receipt of the promised cash flows, and the larger interest coupons on high yield bonds mean the expected payments from interest and principal are received sooner on average. Thus an increase in interest rates of a certain amount implies less of a price decline for a high yield bond than for an investment grade rated bond of the same maturity.

- In addition, rising interest rates usually imply a growing economy, and a growing economy usually means improving creditworthiness and fewer defaults.

Of course it's most unlikely that high yield bonds will deliver returns even close to 2012's performance. On the other hand, they don't have to equal last year's return to warrant holding today.

While yields are near all-time lows, yield spreads tell a very different story. Today the average spread on our U.S. high yield bond portfolios – approximately 490 basis points – is toward the high end of the normal historical range we've invested in for nearly three decades. We believe such an average spread provides more-than-adequate compensation for our default experience, which over the last 27 years has averaged 1.4% per annum. With corporate balance sheets in relatively good shape (thanks in large part to all of the refinancing activity over the past two years), the capital markets awash in liquidity, and economies (at least in the U.S.) showing some strength, default rates are projected to remain below the long-term average for at least the next twelve months.

Given their current average yield spread, we estimate that our portfolios could suffer a default rate of approximately 9% every year and still do no worse than Treasurys – and it's worth noting that we have never had even <u>one</u> year with a 9% default rate. So we don't think high yield bonds are overpriced in relative terms. **In fact, we feel the odds favor their delivering relative performance that is superior to Treasurys and high grade corporates over multi-year holding periods ahead.**

Finally, let's consider the potential absolute result for high yield bonds from today. Suppose we hold (or buy) high yield bonds currently at around 5.7% average yield, and we have Oaktree's average experience: an annual default rate of 1.4% and loss of about half the money invested in the defaulting bonds, or 0.7% of our portfolio per year. **This results in 5% net return per year before fees and price fluctuations. Given the alternatives today, that's an attractive absolute return. What else is better?**

If interest rates rise and/or yield spreads expand, we will suffer price declines (as will holders of all other fixed-rate securities). **But if Oaktree is right in its credit judgments, those declines will prove to be temporar**y. The bonds will be paid off at par upon maturity, and if the other assumptions above are met the 5% return will be achieved.

While we believe spreads are attractive given the risks we see in our portfolios, it is true that there is little room for price upside, making the reward for risk taking limited. (This is in essence what Howard concluded in his most recent memo, "Ditto.") **In this type of environment, superior returns are more likely to be earned through minimizing mistakes than through stretching for yield. Rather than behaving aggressively, the search for return should involve risk control, caution, discipline and selectivity.** Of course, this is what we emphasize in our portfolios.

Considering these factors, should investors sell their high yield bonds and wait for a better time to invest? We don't think so, as **market timing is next to impossible to do right and costly to attempt** in less liquid markets like high yield bonds.

February 21, 2013