JANUARY 3, 2023

2023 High Yield Thoughts - Equity in Bond Clothing

"The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces." – Warren Buffett, 1990 Berkshire Hathaway Chairman's Letter

Summary

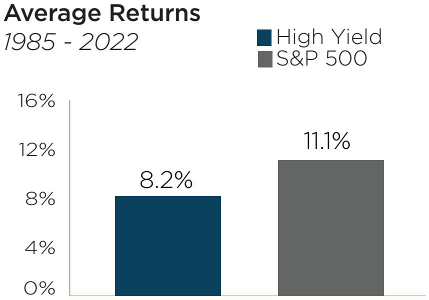
High Yield bonds look very interesting compared to equities heading into 2023. After a devastating 2022 for both stocks and bonds, the average high yield bond price is less than 90 cents on the dollar. When starting from an average price below $90, forward 1-year and forward 3-year annualized average returns for high yield bonds have historically beaten stocks in both absolute and risk-adjusted terms.

A Year to Forget

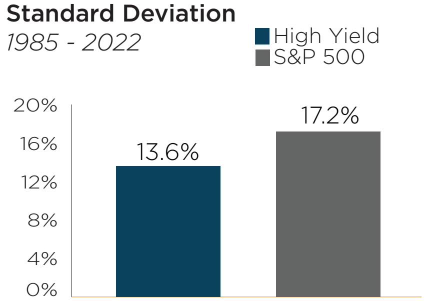
2022 was a year that most investors would soon like to forget. The Federal Reserve's (the Fed) re-set of interest rates had a profoundly negative impact on pricing in fixed income and equity markets. The yield curve ended the year historically inverted, with inflation readings still well above the Fed's target, leaving many to believe that further monetary tightening is on the way. Housing starts have fallen precipitously, the index of Leading Economic Indicators reads negative, and a recession seems widely anticipated in 2023.

Equity in Bond Clothing

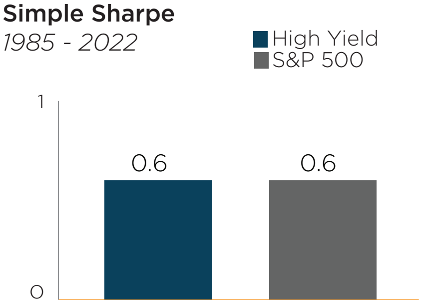
Average Returns
1985 - 2022



Standard Deviation
1985 - 2022



Simple Sharpe
1985 - 2022

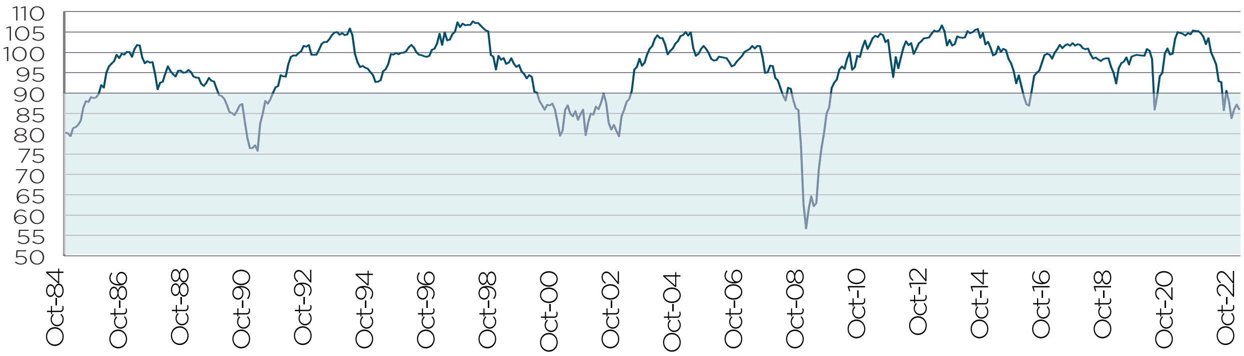


Source: ICE BofA Indices; Bloomberg; Chartwell

From 1985 through 2022, high yield's 8.2% average annual return trailed the S&P 500's average annual return of 11.1%. Note that high yield's standard deviation of return over this period was 21% lower than the S&P 500's, leaving risk adjusted return metrics (i.e., simple Sharpe) nearly identical. The correlation of annual returns between the two asset classes has been 66%. In the current environment, we believe high yield bonds could be a less risky approach to achieve equity-like returns in 2023.

Starting Point Matters

Average High Yield Bond Price
10.31.1984 - 12.31.2022

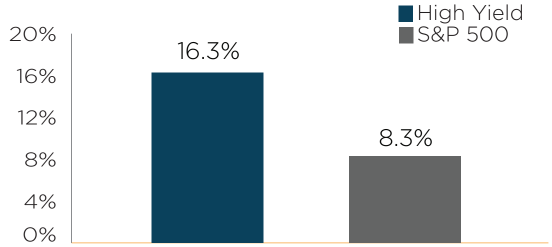


*Blue shading indicates when the price dropped below $90.
Source: ICE BofA US Cash Pay High Yield Index

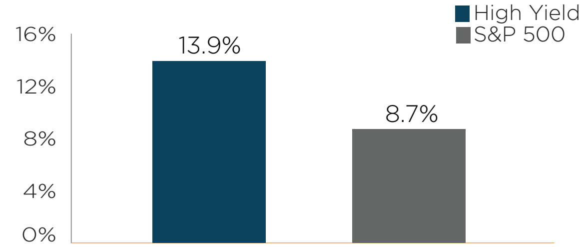
THE PERFORMANCE DATA QUOTED REPRESENTS PAST PERFORMANCE; PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

As seen in the chart above, the average high yield bond price is below $90 to start the year. Why should investors consider high yield bonds heading into a possible recession? Simply put because the starting point, or starting price, matters a lot. Since inception of the ICE BofA US Cash Pay High Yield Index (October 1984), when the average high yield bond price was below $90 at month end, forward 1-year returns have averaged 16.3% and forward 3-year annualized returns have averaged 13.9%. Both results are higher than the S&P 500's average annual return since 1985 of 11.1%. Interestingly, when the average high yield bond price was below $90 at month end, forward 1-year returns and forward 3-year annualized returns *for the S&P 500* have only averaged 8.3% and 8.7% respectively.

Average Forward 1-Yr Return when High Yield Price <$90 at month end



Average Forward 3-Yr Return, annualized, when High Yield Price <$90 at month end



Data for the graphs is a calculated average from October 1984 through December 2022.
Source: ICE BofA Indices; Bloomberg; Chartwell

Contractual bond characteristics, namely a fixed maturity price ($100) on a fixed maturity date, do not go away during low price environments, except of course for those individual issuers that succumb to default. We believe active management in high yield and fundamental credit research can be helpful in mitigating default risk. Looking deeper at the distribution of returns during these forward time periods, we see that high yield's lower volatility profile persisted, making historical returns during these periods better than stocks in both absolute and risk-adjusted terms.

	Average High Yield Price <$90 at month end Average Forward 1-Year Statistics		*Average High Yield Price <$90 at month end Average Forward 3-Year Statistics*	
	High Yield	**S&P 500**	**High Yield**	**S&P 500**
Average Annual Return	16.3%	8.3%	13.9%	8.7%
Standard Deviation	16.8%	23.2%	5.0%	9.3%
Simple Sharpe	1.0	0.4	2.8	0.9
Maximum Return	63.2%	56.3%	25.5%	25.5%
Minimum Return	-23.0%	-43.3%	3.2%	-16.1%

Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

Not Ready to go Full Throttle Junk?

Highly risk-aware investors may still have an aversion to owning high yield bonds to begin 2023. Investors in this camp might consider a 'high yield-lite' approach that focuses on the highest quality issuers (BB-rated) with the shortest maturities (less than 5 years). While not as long a performance history, the ICE BofA 1-5 Year BB Cash Pay High Yield Index incepted in 1996, and since then has posted an average forward 1-year return of 11.4% when the broad high yield market had a month-end average price below $90. This compares with an average return of 8.5% for the S&P 500 since 1996.

Closing Thoughts

Every economic cycle is different. For investors today, uncertainty abounds around corporate earnings, interest rates, inflation, and the economy. We do not know what lies ahead for the markets, but we believe investors should be prepared for continued volatility. In the current high yield market, we like lower dollar price, higher quality issuers for their total return potential, particularly in the homebuilding and technology sectors. Considering their relatively low prices today, history suggests that high yield bonds could be a profitable alternative to equities over the intermediate term.

Risk information: Investing involves risk, including risk of loss.

Definitions

Active Management means that an investor, a professional money manager, or a team of professionals is tracking the performance of an investment portfolio and making buy, hold, and sell decisions about the assets in it.

Average Annual Return (AAR) measures the money made or lost by a mutual fund over a given period.

Bond is a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

Default is a position considered defaulted if the next interest payment is not expected to be received.

ICE Bank of America (ICE BofA) 1-5 Year BB Cash Pay High Yield Index is a subset of the Bank of America U.S. Cash Pay High Yield Index and tracks the performance of BB rated U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market with maturities of 1 to 5 years.

ICE Bank of America (ICE BofA) US Cash Pay High Yield Index is an unmanaged index used as a general measure of market performance consisting of fixed-rate, coupon-bearing bonds with an outstanding par which is greater than or equal to $50 million, a maturity range greater than or equal to one year and must be less than BBB/Baa3 rated but not in default.

High-yield bonds are debt securities, also known as junk bonds, that are issued by corporations. They can provide a higher yield than investment grade bonds, but they are also riskier investments.

Leading Economic Indicators are a measurable set of data that may help to forecast future economic activity. Leading economic indicators can be used to predict changes in the economy before the economy begins to shift in a particular direction.

Risk Adjusted Return is a calculation of the profit or potential profit from an investment that takes into account the degree of risk that must be accepted in order to achieve it.

Sharpe Ratio compares the return of an investment with its risk. The greater an investment's sharpe ratio, the better its risk-adjusted performance has been.

Standard and Poor's 500 Index (S&P 500) is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

Standard Deviation is a measure of volatility regarding investment returns. The larger the standard deviation, the wider the range of returns tends to be. In contrast, an investment with a small standard deviation tends to have more consistent returns.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

For further information regarding our strategies please contact Chartwell at 610-296-1400 or info@chartwellip.com.

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