GW&K
INVESTMENT MANAGEMENT

HIGH YIELD
MARKET UPDATE

May 2016

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EXECUTIVE SUMMARY

The severe commodity selloff that began in late 2014 has had a profound impact on the high yield market, but the damage did not extend through all segments of the market. It is important to look at high yield by sector as well as by quality buckets to assess where the risks and opportunities are most present.

- The commodity related sectors of **Energy and Metals & Mining suffered the most damage**.
- Rise in default rates is occurring largely in commodity sectors and among the lower quality segments of the high yield market.
- The majority of the **U.S. high yield market is fundamentally sound**.
- Higher quality high yield bonds offer more attractive risk return opportunities within the space, and relative to other fixed income market segments.

High yield corporate bonds are securities issued by companies that typically have elevated leverage. The asset class has garnered negative attention since late 2014 due to volatile returns caused by the heavily represented commodity sectors (15-20% of most high yield indices). While this is somewhat justified, it is important to distinguish the commodity sectors from the rest of the high yield market. The high yield market is greatly bifurcated and commodity headlines are masking a fundamentally sound environment for the majority of the asset class. Further, it is important to segment the high yield market by quality tiers as returns, volatility, and default rates vary drastically by quality group.

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WHY INVEST IN HIGH YIELD?

A high yield allocation can provide beneficial portfolio diversification given its low correlation to other asset classes. As can be seen in Exhibit 1, since 1984, high yield has exhibited a relatively low correlation to other fixed income asset classes as well as to equities.

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Exhibit 1: Correlations

Barclays High Yield Index vs. Other Asset Classes
1/1/84 - 3/31/16

	High Yield	Cross-over	US Credit	S&P 500	EM*	Govt	US Agg	Ba	B	Caa	Lev Loans**
Crossover	0.92										
Credit	0.53	0.66									
S&P 500	0.58	0.56	0.29								
EM	0.59	0.59	0.48	0.55							
Govt	0.08	0.13	0.78	0.01	0.13						
Agg	0.29	0.40	0.90	0.15	0.31	0.95					
BA	0.94	0.98	0.63	0.56	0.60	0.20	0.42				
B	0.98	0.86	0.48	0.56	0.57	0.06	0.28	0.90			
Caa	0.90	0.78	0.34	0.53	0.50	-0.08	0.11	0.78	0.86		
Lev. Loans	0.77	0.73	0.33	0.44	0.40	-0.31	-0.02	0.74	0.71	0.78	

Based on monthly returns. *Emerging Markets (EM) since 1994. **The Time Series for the Loan Index includes the S&P/LSTA Leveraged Loan Index prior to 2006 and the Barclays High Yield Loan Index beginning in January 2006.
Source: Barclays U.S. High Yield Corporate Update, April 2016

Looking at these same asset classes on a risk-adjusted basis (Exhibit 2) shows that the highest quality tier of high yield (Ba) has generated the best risk-adjusted returns since 1984. Certainly, over very short periods of time, correlations and returns can be skewed given severe macro events, but over a complete credit cycle, higher quality high yield has held up well.

Sharpe Ratio A risk-adjusted statistic that measures reward per unit of risk (higher is better). Calculated as portfolio excess return over a risk-free rate divided by the standard deviation of portfolio returns.

Exhibit 2: Sharpe Ratios

Barclays High Yield Index vs. Other Asset Classes
1/1/84 - 3/31/16

	High Yield	Cross-over	US Credit	S&P 500	EM*	Govt	US Agg	Ba	B	Caa	Lev Loans**
Sharpe Ratio (1984-2016)	0.58	0.60	0.73	0.47	0.51	0.72	0.86	0.83	0.23	0.23	0.37
Sharpe Ratio (1984-1989)	0.60	N/A	0.83	0.62	N/A	0.76	0.83	1.11	-0.52	-0.52	N/A
Sharpe Ratio (1990-1999)	0.75	0.81	0.62	0.94	0.21	0.55	0.64	0.98	0.49	0.49	0.14
Sharpe Ratio (2000-2009)	0.36	0.31	0.55	-0.17	0.67	0.66	0.81	0.51	0.19	0.19	0.23
Sharpe Ratio (2010-2016)	1.03	1.38	1.27	0.82	1.04	1.21	1.62	1.36	0.48	0.48	1.12

Annualized data. *Emerging Markets (EM) since 1994. **The Time Series for the Loan Index includes the S&P/LSTA Leveraged Loan Index prior to 2006 and the Barclays High Yield Loan Index beginning in January 2006.
Source: Barclays U.S. High Yield Corporate Update, April 2016

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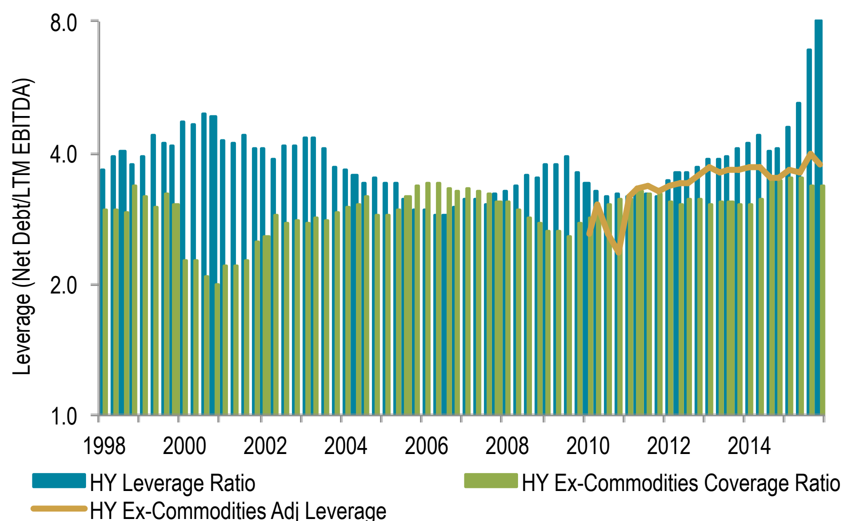
FUNDAMENTALS

The severe commodity selloff that began in late 2014 has had a profound impact on the high yield market. The global price weakness in a variety of commodities has caused numerous ratings downgrades, defaults, distressed exchanges, and bankruptcies. The price movement can be attributed to a multitude of factors including global economic softness, weaker Chinese demand, over-supply globally, and questionable cartel behavior; however, the impact on high yield issuers' financial strength outside of the commodity sectors has been minimal. As shown in Exhibit 3, net adjusted leverage stacks up favorably versus the last two recessions.

Exhibit 3: High Yield Leverage Ratios

1998 - 2015

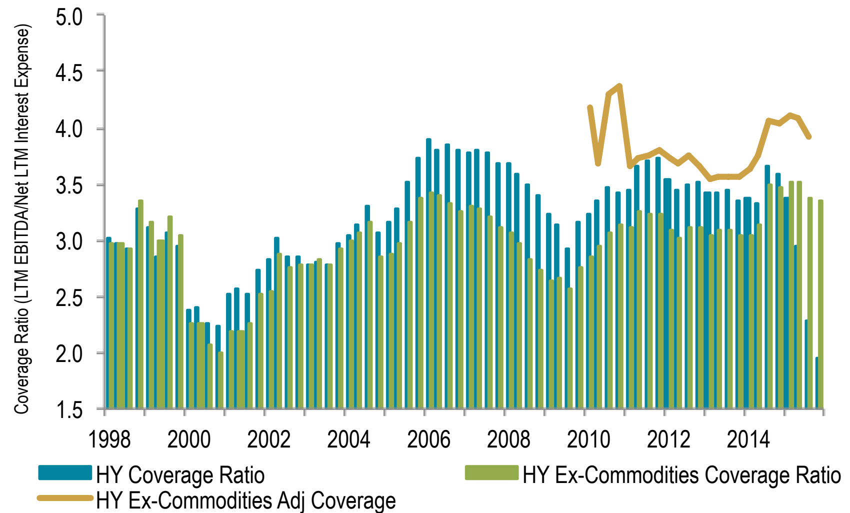


Commodities are defined as issuers in the Energy or Materials sectors. Energy contains upstream, midstream and downstream companies. Materials contains Metals/Mining, Chemicals and Paper companies. Leverage is a company's total balance sheet debt less cash divided by total EBITDA (earnings before interest, taxes, depreciation, and amortization). The higher the result, the higher the leverage and, all else being equal, the more risky the credit. Source: BofA Merrill Lynch Issuer Fundamentals, April 2016

... the ability of high yield companies outside of the commodity space to service their debt commitments remains quite healthy...

Likewise, the ability of high yield companies outside of the commodity space to service their debt commitments remains quite healthy, as shown in Exhibit 4.

Exhibit 4: Interest Coverage of High Yield Companies
1998 - 2015



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...fundamentals outside the commodity sectors are not necessarily deteriorating, but are actually stable or improving.

Similar results are produced when looking at sales growth and cash flow as well – fundamentals outside the commodity sectors are not necessarily deteriorating, but are actually stable or improving.

Current default rates are around 3.22% for high yield overall, but only 0.41% when commodity sector issuers are excluded. As reflected by Moody's (Corporate Default and Recovery Rates, February 2016), CCC-rated debt defaults averaged 12.0% over the last 25 years versus 0.72% for BB-rated debt. Further, over the last 10 years, CCC-rated debt has actually produced negative price returns (-3.26% annualized, BofA Merrill Lynch), thereby relying on coupon income to overcome this deficit. High yield investors must appreciate not only the differences among sectors, but by the quality group as well.

TECHNICALS

Toggle Note A payment-in-kind (PIK) bond, where the issuer has the option to defer an interest payment by agreeing to pay an increased coupon in the future. With toggle notes, all deferred payments must be settled by the bond's maturity.

The volatility that investors have been experiencing in a segment of the high yield market has been impactful on many levels. Overall, new issuance of bonds is down approximately 38% year over year (JP Morgan, Credit Strategy Weekly Update, April 22, 2016). As one would expect, this is largely due to the anemic supply coming out of the commodity sectors. Additionally, higher risk instruments as reflected by their rating quality (i.e. CCC) or their structure (PIK or toggle notes) has been minimal. New supply in the form of bonds downgraded from investment grade to high yield (fallen angels) is approaching $140 billion – this provides an absorption challenge given the size and composition (primarily commodity related) of

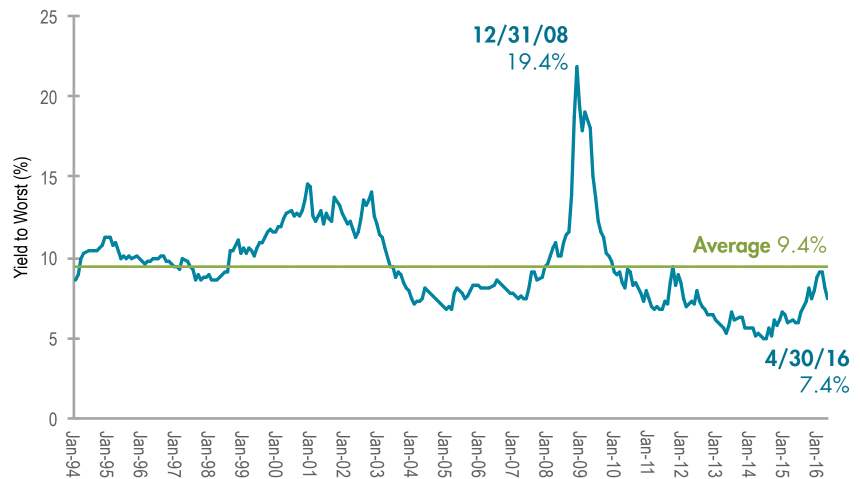
the fallen angels. Finally, ETF's participation in the market has grown over the past several years and can create price volatility in specific bond issues. All of this volatility provides tremendous opportunities in the asset class.

VALUATION

When looking at valuations on a yield to worst basis, high yield does not look overly compelling versus its long-term average given low Treasury yields (Exhibit 5).

Exhibit 5: High Yield Corporate Bond Yields

1994-2016

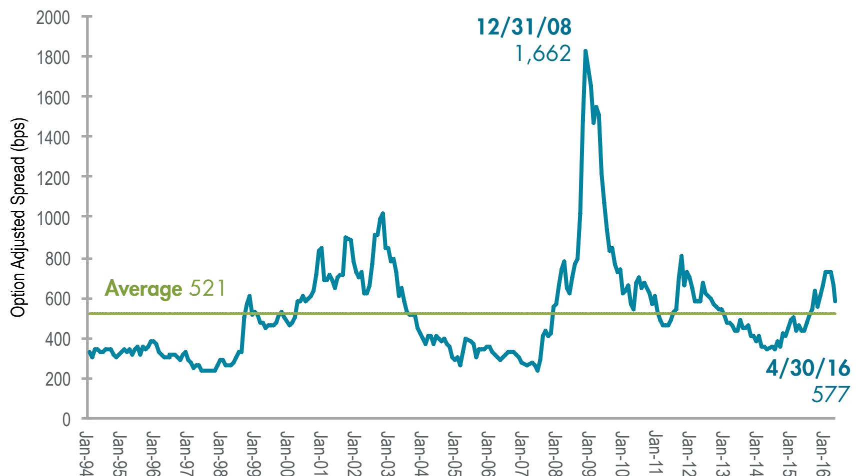


Source: Barclays

However, on a spread to worst basis, the asset class looks more attractive (Exhibit 6).

Exhibit 6: High Yield Corporate Bond Option Adjusted Spreads

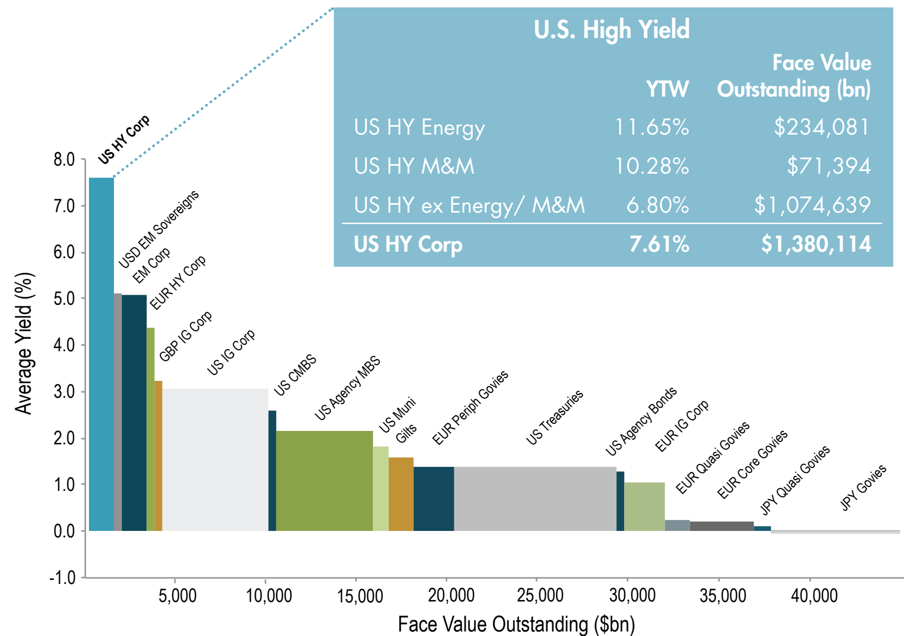
1994-2016



Source: Barclays

If we focus only on the higher quality (BB rated) companies, the spread to worst as of 4/30/16 was around 371 basis points which corresponds to a 5.22% yield to worst. Taking it a step further, removing Energy and Metals & Mining debt from the BB universe generates a spread of 343 basis points and a yield of 4.91%. Depending on an investor's risk tolerance, these highlighted segments of the market look attractive with respect to the opportunity set in fixed income – see Exhibit 7.

Exhibit 7: Global Fixed Income Market Average Yields
4/30/16



Source: BofA Merrill Lynch, FactSet

MACRO CONCERNS

The impact of some of the bigger macro concerns on capital markets should be less meaningful on high yield issuers. Should the Fed accelerate their call for higher interest rates, high yield would likely fare well. A rising rate environment is usually associated with an improving economy, which is beneficial to high yield. Additionally, high yield debt has less interest rate sensitivity given that it has a relatively shorter duration than the rest of the fixed income market. The asset class is also primarily exposed to the belly of the Treasury curve and therefore less affected by rising short-term rates. Lastly, high yield companies (ex-commodity) tend to be North American-centric and less impacted by Chinese weakness or a strong U.S. dollar. While certainly not insulated from all things negative, several segments of the high yield market are better positioned than others.

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CONCLUSION

The high yield market is bifurcated between commodity sectors and everything else. It would be inaccurate to surmise the fundamental health of high yield issuers without acknowledging the drastic differences within the high yield universe. The great majority of the high yield market is financially sound. Concerns over high default rates can largely be channeled towards commodity sectors and/or the lowest rating quality issuers within the asset class. Micro rallies/selloffs are to be expected for the asset class as a whole, and depending on risk tolerance, provides opportunities within sectors and quality groups.

ABOUT GW&K

GW&K was founded in 1974 to offer innovative investment solutions consistent with our clients' objectives. Our company has grown from a local provider of investment management services to a nationally recognized manager with broad investment capabilities. We first gained attention for our municipal bond expertise, and it remains one of the cornerstones of our investment offerings. Through the years we introduced a range of equity and taxable bond strategies that stay true to our core principles of active management, independent research and an eye toward quality. Today we serve a diverse client base of individuals and institutions.

Our firm has been under continuous senior management since our founding, and now we have the benefit and support of our partner firm, Affiliated Managers Group. Through this partnership we continue to operate independently, maintain our client oriented culture and focus on delivering personalized investment management services.

This represents the views and opinions of GW&K Investment Management. It does not constitute investment advice or an offer or solicitation to purchase or sell any security and is subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

Fixed income investments are subject to interest, credit, and market risk. Interest rate risk: the value of fixed income investments will decline as interest rates rise. Credit risk: the possibility that the borrower may not be able to repay interest and principal. Low rated bonds generally have to pay higher interest rates to attract investors willing to take on greater risk. Market risk: the bond market in general could decline due to economic conditions, especially during periods of rising interest rates.

Higher yielding, lower rated securities involve greater price volatility and present greater risks than higher rated fixed income securities.

GW&K assumes no responsibility for the accuracy of the data provided by outside sources. Sources for indexes and other external data include Barclays, Bloomberg, JP Morgan Research, and BofA Merrill Lynch Global Research.

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