the advisory group | Not just advice. Attention.

**Gregory Schill, CFP®**
3480 Torrance Blvd.
Suite 102
Torrance, CA 90503
310-536-7111
gschill@theadvisorygrp.com
www.theadvisorygrp.com

# Junk Jitters: What's Behind the Exodus from High-Yield Bonds?

***For many investors, high-yield bonds and bond funds occupy a strategic space between stocks and less risky bonds.***

For the one-week period ending on November 15, 2017, investors withdrew a net $4.43 billion from U.S. funds holding high-yield bonds (often called junk bonds) — the third largest exodus from such funds on record.[1] The high-yield market stabilized over the next two days, but the mass sell-off rang alarm bells for some market analysts.

Large outflows from junk-bond funds are sometimes considered to be an indication of potential weakness in equity markets — a canary in the market coal mine. While this remains a concern, a closer analysis suggests that the recent sell-off may be more specific to high-yield bonds and their role in the current investment climate.

## Risk and reward

High-yield bonds are corporate bonds that offer a higher rate of interest because they carry a higher risk of default. They typically carry a credit rating below BBB from Standard and Poor's and below Baa from Moody's. High-yield bond issuers may be companies that are highly leveraged or experiencing financial difficulties. They might also be start-ups or small companies with limited financial resources.

Despite the negative connotation of the term "junk bond," these bonds are widely held by investors, especially in mutual funds and exchange-traded funds (ETFs), which mitigate the default risk for any individual bond. The appeal, of course, is the higher yield compared with less risky investment-grade corporate bonds or government bonds. The default risk of high-yield bonds is still relatively small when compared with the risk of investing in equities, so for many investors, high-yield bonds and bond funds occupy a strategic space between stocks and less risky bonds. For this reason, a retreat from high-yield bonds may suggest that investor shave a lower appetite for risk that might extend to equities.

## Chasing yield

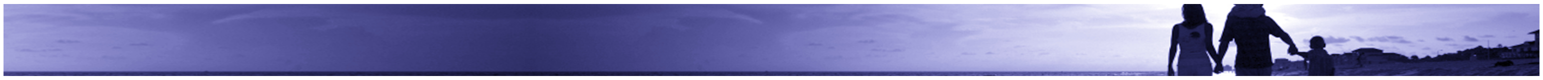
In the low interest-rate environment of the last decade, high-yield bonds have been especially attractive to investors. This has driven prices upward, which reduces the effective yield due to the inverse relationship between bond prices and yields (i.e., the higher the price for a bond with a fixed coupon rate, the lower the yield).

In late October, the "spread" in interest rates between high-yield bonds and Treasury bonds neared the lowest level in a decade, meaning that investors were getting less of a premium for assuming higher risk.[2] A November survey found that 60% of high-yield investors believed the bonds were overvalued.[3]

## Telecom and taxes

The recent fund sell-off may be a natural response to high prices — taking profits and looking for other opportunities.[4] However, the sell-off was triggered by weakness in the telecom industry, where some companies have struggled with failed mergers and poor earnings. Because telecom debt accounts for a large portion of holdings in high-yield bond funds, losses on telecom bonds drove fund prices downward.[5]

There are also concerns about the effect of rising interest rates and the potential impact of proposed tax changes that would limit deductions for interest expenses.[6]



## A long-term view

In general, corporate credit remains solid and corporate earnings remain strong.[7] The bull market is old, but many analysts believe it still has legs.[8] The greatest danger of the high-yield sell-off may be psychological — the potential for investors to overreact to a small sign of market weakness.

The role, if any, of high-yield bonds or bond funds in your portfolio should be based on strategic objectives appropriate for your goals, time frame, and risk tolerance. A brief hiccup in that segment of the bond market should not change your objectives; however, you might consider whether you are taking on too much risk in your fixed-income investments at a time when interest rates are beginning to rise.

## Some considerations

A bond fund is a mutual fund or ETF composed mostly of bonds and other debt instruments. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.

The return and principal value of fund shares, and of bonds redeemed prior to maturity, fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Supply and demand for ETF shares may cause them to trade at a premium or a discount relative to the value of the underlying shares.

Investing in high-yield bonds offers different rewards and risks than investing in investment-grade securities. These include higher volatility, greater credit risk, and the more speculative nature of the issuer.

U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest. Like all bonds, the principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid.

*Funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.*


1, 4, 6) MarketWatch, November 18, 2017

2) Federal Reserve Bank of St. Louis, 2017

3) *The Wall Street Journal,* November 16, 2017

5, 7) *The Wall Street Journal,* November 17, 2017

8) *Forbes,* November 21, 2017


---