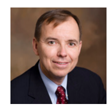
Secular Risk Creates New Opportunities in High Yield Bonds

Taking advantage of disruptive forces reshaping the market

May 2019

KEY INSIGHTS

- A growing number of companies are facing potential secular risk that could impair their long-term growth prospects.
- The forces of disruption are reshaping the high yield bond market and creating a new generation of companies to invest in.
- Even companies challenged by secular risk can provide attractive investment opportunities for high yield bond investors.



Mark Vaselkiv
Chief Investment Officer, Fixed Income, and Manager, High Yield Fund

With significant technology innovation and disruption unfolding across the U.S. economy, a growing number of companies are facing risks that could result in lower revenues, earnings per share, and valuations in future years. While observers typically associate disruption with equity investing, meaningful change also exists in the credit markets. Some sectors of the high yield bond market appear particularly susceptible. At the same time, this trend has created a new generation of high yield companies that offer attractive investment opportunities.

Value-Oriented Companies Most Susceptible To Secular Risk

We define secular risk as the emergence of a new competitive force, technological advance, change in customer habit, or regulatory change that can substantially undermine a company's long-term growth potential. Our equity analysts estimate that about 31% of the U.S. stock market is impacted by secular risk, compared with about 20% just two years ago.

Traditional value-oriented industries and companies are most susceptible to secular risk, in our view, and high yield is essentially a value-driven market. Many value-oriented companies have taken on more debt on their balance sheet, which amplifies the secular risk some face.

Some industries facing disruptive change, such as autos, cable, gaming, publishing, mining, broadcasting, and retailing, are not as prominent in the high yield market now as they once were. While the stocks of such companies may not be attractive over the long term, we find opportunities in these sectors by investing in shorter-term debt securities.

Investors May Want To Consider Debt Of Disrupted Companies

The transition to autonomous electric vehicles may perhaps be achieved within

USD 10 billion

Amount Netflix spends annually to develop new content

the next decade, which would have profound implications for the traditional auto industry. For my entire career, the automotive industry has been a key part of the high yield market. The stock and longer-term bonds of automaker Ford Motor, a laggard in autonomous vehicle development, may not be very enticing. We can choose to participate in these disrupted credit situations because we can determine the time horizon for our investment, which may be much shorter than that of an equity investor. That gives us more flexibility to invest in companies that may ultimately face disruptive challenges.

Also, companies most exposed to secular risk are not necessarily on the verge of insolvency. Because debt investors prioritize an issuer's ability to meet its repayment obligations over its ability to grow, it may make sense to own the debt rather than the equity of a company that is susceptible to secular risk. In this sense, high yield has become a relevant strategy for uncovering value in this era of disruption.

A New Generation Offers New Opportunities

Meanwhile, some of the new-generation companies that we believe are on the right side of change may not generate strong cash flow like the businesses we have traditionally invested in. Many are still in the development stage. But, given the value of these businesses and their rapid growth, they may soon reach a point of cash flow inflection.

Among media companies, Netflix is one of the largest positions in our high yield strategy. Netflix generates about USD 2 billion of operating cash flow, but it spends about USD 10 billion annually to develop new content in the United States and internationally. The company also hasn't scratched the surface in terms of international programming. Netflix finances its content development with 10-year bonds issued in the high yield market, borrowing about every six months. These bonds have been solid investments.

In the transportation area, Tesla stock has not performed well this year, but the bonds have outperformed its equity. A recently completed common stock and bond issuance has helped to shore up the balance sheet and improve liquidity, while we wait for production volumes of refreshed models to improve. Like Netflix, Uber burns through a lot of cash and has borrowed in the high yield market over the past three years. We have invested in these bonds, and they have performed well even though the company is not yet profitable. We believe that ultimately the ride-sharing industry will have two players—Uber and Lyft. These companies should mature and coexist well together. Historically, such oligopolies have worked well economically.

Opportunities In Energy And Utilities Sectors

Energy is the largest sector in the U.S. high yield market and is confronting disruptive change from technological advances in horizontal drilling, enabling access to significant new reserves of oil and gas. We have invested billions of dollars in smaller exploration and production high yield issuers that are buying acreage and operating in fertile areas like the Permian Basin. They are exploiting these reserves in ways that were historically not economically feasible.

Utilities, once considered a sleepy, defensive sector, is innovating with the advent of new technologies fostering renewable energy alternatives. NextEra, for example, operates a traditional utility (Florida Power and Light) and is also a leader in development of solar, wind, and hydro energy, helping drive growth while lowering customers' bills.

Cable Companies Generate Strong Cash Flow

In the broadcasting arena, cable television has long been a major sector in the high yield market. With consumers increasingly accessing content on their phones or other mobile devices, the industry faces

> Secular risk is also providing high yield investors with a new generation of companies that offer exciting opportunities.

considerable competitive pressure. Some of these cable companies may not exist in 20 years. But they remain major providers of internet service for small businesses and consumers, and have generated strong cash flow, so the cable companies should continue to be good high yield investments over the next five years. The cable industry is another example in which owning the bonds may be more favorable than the stock.

It's also interesting to note that not all companies that find themselves on the wrong side of change stay there. Some can actually be revived by disruptive change. iHeartMedia, for example, is the largest traditional radio broadcasting company in the United States. The company is on the verge of exiting bankruptcy with significant upside potential in an industry that was disadvantaged. It is benefiting from a renaissance in radio broadcasting and listening facilitated by smart speakers in the home. iHeartMedia owns Z100, the largest FM station in New York City, which has clearly benefited from this positive disruptive change.

Disruption Generates Opportunities Along With Challenges

Secular risk has certainly made it more challenging to invest in many of the value-oriented companies that dominate the high yield market. But it is also providing high yield investors with a new generation of companies that offer exciting opportunities. And with T. Rowe Price's global research capabilities, we can collaborate closely with our equity analysts to identify those companies that may succeed as well as those that may be ripe for disruption.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T. Rowe Price®

Important Information

Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of May 2019 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

As of March 31, 2019, the High Yield Fund had 4.95% of its assets invested in securities mentioned in this article as follows: (Ford Motor, 0.43%; Netflix, 1.31%; Tesla, 0.98%; Uber, 0.86%; NextEra, 0.43%; and iHeartMedia, 0.94%.) The fund did not own Lyft at that time.

The fund is subject to the risks of fixed-income investing, including interest rate risk and credit risk. High yield bond and loan issuers are usually not as strong financially as investment-grade bond issuers and, therefore, are more likely to suffer an adverse change in financial condition that would result in the inability to meet a financial obligation. Accordingly, securities and loans involving such companies carry a higher risk of default and should be considered speculative.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

ID0002254 (05/2019)
201905-839059