T. Rowe Price

Exploiting durable inefficiencies in high yield debt

From the Field
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Key Insights

- Despite the broad characterization, not all high yield debt is created equal.
- Supply and demand imbalances in the high yield bond market contribute to a consistent opportunity to buy BB bonds at a discount.
- By understanding where we are compensated for risk across and within asset classes, we can allocate capital in pursuit of superior risk-adjusted returns.

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Our approach as active managers is to try to add value in a variety of ways, from fundamental research to individual security selection to a superior asset allocation mix. One of the core tenets of our approach to active management is identifying and exploiting what we believe to be durable market inefficiencies—that is to say, market segments where the price of an asset doesn't correctly reflect its value. In this piece, the first of a three-part series, we examine a selection of these inefficiencies.

High yield debt is not a monolith

When we analyze high yield issues, we consider factors such as the issuer's underlying fundamentals, credit rating, and the issue's duration. Through our analysis, we have observed persistent mispricing in the BB credit tranche, which is priced more like lower-quality issues than lower-rated issues despite having much lower default risk than lower-rated issues and better absolute and risk-adjusted returns than higher-quality issues.

At a base level, one might assume that the distribution of default probability is spread evenly across credit ratings, with AAAs being incrementally less likely to default than AAs, and so forth. While this is accurate for investment-grade issues, it demonstrably has not been the case for high yield bonds, where the distribution of default rate is closer to exponential as we move down the credit spectrum.

When comparing the default rates of BBBs and BBs (Fig. 1), both quite low, we would expect BBs to trade at only a slight discount to BBBs. In practice, markets tend to price

(Fig. 1) Average one-year corporate default rates, 1998–2023

Rating	AAA	AA	A	BBB	BB	B	CCC/C
Default Rate	0.00	0.04	0.08	0.18	0.50	4.07	30.18
Yield to Maturity	4.04	3.99	4.46	5.15	6.85	8.68	13.05

As of December 31, 2023.
Default rate sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.
Credit ratings are provided by S&P Global. A rating of "AAA" represents the highest-rated securities, and a rating of "CCC", "CC", "C" represents the lowest-rated securities which are not in default.
The default rate represents the percentage of all outstanding loans that a lender has written off as unpaid after a period of missed payments.
Yield-to-maturity calculated by T. Rowe Price Associates as an average based on Barclays monthly data series.

BBs more like Bs, which had significantly higher default rates. This raises the question: Are markets overcompensating BB bond investors for risk, and if so, why?

Risk and return

A bond's credit rating directly impacts its yield. The lower the quality, the higher the rate. This is conventional wisdom that almost does not bear mentioning. However, from a fixed income investing perspective, we are focused not only on an issue's yield but on capital return as well.

Despite having lower yields than Bs, BBs generated a higher average annual return (Fig. 2). This is due not only to their lower default risk, but also because BBs have typically been priced comparably closer to Bs in the market. As prices and yields are inversely related, these lower prices have the effect of increasing the actual return generated by BBs. Moreover, because the actual default rate for BBs has been quite low and volatility within the tranche has been more comparable to higher-quality issues, BBs also generated better risk-adjusted returns than their BBB counterparts.

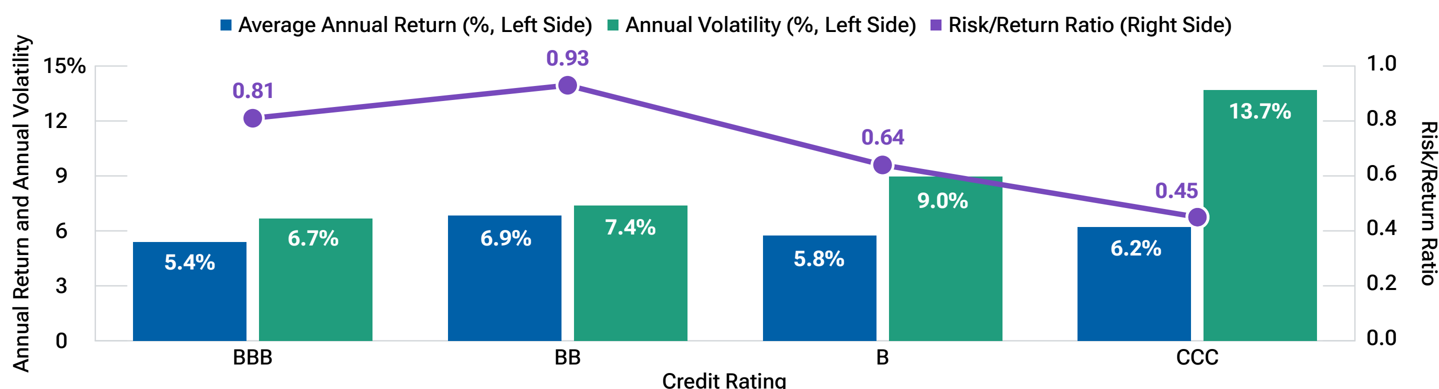
Durable inefficiency

In the Capital Appreciation Fund and Capital Appreciation and Income Fund,[1] investing in this segment of high yield bonds is a core tenet of our investment process and a key way in which we seek to generate alpha.[2] We think this inefficiency has continued to exist because of key factors that contribute to an imbalance between supply and demand, which has allowed us to consistently purchase these bonds at a discount.

- Regulatory requirements placed on some institutional investors, such as insurance companies and pension funds, typically prohibit or limit the purchase of below investment-grade debt. For insurance companies in particular, the amount of capital required to be held against a BB bond is materially higher than for a BBB bond. These requirements have the effect of artificially suppressing demand for

[1] The T. Rowe Price Capital Appreciation Fund and Capital Appreciation and Income Fund share the same lead portfolio manager and investment research process. However, the funds' implementation of the research process varies including, but not limited to, differences in product structure, asset allocation, trading, and fees and expenses. There is no guarantee that the funds will perform similarly in any market environment. Review the prospectuses for detailed information on the funds' strategy, fees, and risks.
[2] When a rating is available from all three agencies, the median rating is used. If there are two ratings, the lower rating is used and if only one rating is available, that rating is used. Credit ratings for the securities held in the portfolio are provided by Moody's, Standard & Poor's, and Fitch. A rating of "BB" is the highest non-investment-grade rating. If a rating is not available, the security is classified as Not Rated. The rating of the underlying investment vehicle is used to determine the creditworthiness of securities. The portfolio is not rated by any agency. T. Rowe Price does not evaluate these ratings but simply assigns them to the appropriate credit quality category as determined by the rating agency.

(Fig. 2) BB bonds generated better risk-adjusted returns



Performance quoted represents past performance which is not a guarantee or a reliable indicator of future results.
Data reflect the the period from January 1, 1998, through September 30, 2024.
Sources: 2023 S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

(Fig. 3) Risk/return is more normally distributed in U.S. fixed income than in large-cap stocks

	S&P 500		U.S. Corporate Bonds (IG+HY)	
Tile	Lower Risk	Higher Risk	Lower Risk	Higher Risk
Mean Return (%)	10	8.8	1.5	5.9
Standard Deviation, Annualized (%)	11	35	5	18
Return/Standard Deviation	0.9	0.25	0.31	0.33

Performance quoted represents past performance which is not a guarantee or a reliable indicator of future results. Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.
Data are from January 1, 2000, to November 30, 2023, using the S&P 500 Index and the Bloomberg US Corporate Credit and High Yield Indices. Returns are absolute and risk-adjusted over an assumed 12-month holding period. Risk is calculated using stock return volatility for the equities and volatility of option-adjusted spreads for bonds. Mean return for bonds reflects returns in excess of 10-year U.S. Treasury returns.
The universe of securities is divided into two risk buckets based on trailing 12 month standard deviation for equities and option adjusted spread for bonds. The universe is constituted on a rolling monthly basis with returns being calculated over a 12 month subsequent period.

what could otherwise be compelling investment opportunities.

- Investor constraints and incentives also reduce demand for high yield bonds broadly and for BB corporate bonds specifically. Investment-grade credit strategies, for instance, often have limited ability to purchase below investment-grade debt because of regulatory or client restrictions. On the other hand, many managers of high yield bond strategies are disincentivized to have relatively high allocations to BB bonds because, while they have tended to outperform over longer periods, they can also underperform the broader high yield market markedly over a given calendar year. Because of this, we see benchmark hugging from some active managers that also artificially suppresses demand.

- Passively managed investment-grade corporate credit strategies also play a role here. When bonds that may be held in these strategies are downgraded from investment grade to below investment grade, we see forced selling as a direct result, which pushes up on supply and reduces their price.

Working in concert

We believe our focus on identifying compelling investment opportunities can enable us to capture better absolute and risk-adjusted returns without taking on excessive default or total portfolio risk. In part, this is driven by an integrated approach to diversification[3] across and within asset classes, including fixed income and equities.

Within fixed income, for example, we seek to manage credit and duration through diversification that accounts for the inherent characteristics of different types of debt. While high yield bonds have credit risk and lower duration risk, leveraged loans have credit risk and very minimal duration risk, and U.S. Treasuries have very minimal credit risk but do have duration risk. By owning all of these fixed income assets, we can diversify our portfolio in an effort to deliver lower volatility.

More broadly, when investing across asset classes, our higher credit exposure is complemented by a lower volatility bias that we seek to build into the equity portion of the Capital Appreciation Fund and the Capital Appreciation and Income Fund through individual security selection. In practice, this is another way in which we try to maximize potential return relative to portfolio risk.

Our analysis (Figure 3) demonstrated that, on average, lower-risk stocks outperformed higher-risk stocks on an absolute and risk-adjusted basis. Conversely, in looking at the universe of U.S. corporate bonds, both investment grade and high yield, a comparable premium is not evident even after controlling for credit rating and duration.

Because we believe that there is a premium associated with lower-volatility equities, we think we are better rewarded over a full market cycle to take a relatively more defensive posture within the equity component of a portfolio and, conversely, to take a more risk-tolerant posture within fixed income through higher credit exposure.

Confidently contrarian

As portfolio managers, we are willing to go against consensus, question commonly held assumptions, and follow through on our research and process. The high yield market offers one such opportunity to cut against the grain and pursue attractive risk-adjusted returns in an area we think the market underappreciates and misunderstands. Through fundamental research, taking a longer view, and asking the right questions, we are committed to uncovering opportunities that can add value for our shareholders.

[3] **Diversification cannot assure a profit or protect against loss in a declining market.**
For definitions of financial terms, please see: **http://www.troweprice.com/glossary**

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