The Case for Global High Yield

Equity-Like Returns with Lower Risks

Global high yield is an attractive asset class that we believe should be considered as a permanent part of an overall asset allocation—in place of U.S. high yield and even as a surrogate for an equity allocation. Examining the asset class's long-term history, global high yield has provided an attractive total return, outpacing equities on both an absolute basis and after adjusting for volatility. Due to its income potential and higher position in the capital structure, global high yield has generally outperformed equities during economic downturns while retaining some upside potential during economic recoveries. Typically, high yield allocations have been deployed on a tactical basis in response to business cycle changes. However, given the compelling, long-term characteristics of the asset class—similar returns to equities with lower volatility and potential diversification benefits—we contend that global high yield deserves a permanent allocation in more risk-tolerant investment plans, replacing domestic high yield and even equity allocations.

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"HE THAT LIVES UPON HOPE WILL DIE FASTING" - Benjamin Franklin

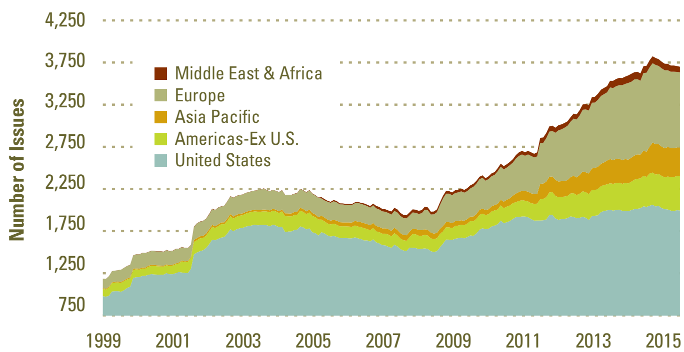
Ever since the collapse of Drexel Burnham Lambert in 1990, high yield bonds have been unable to shake the label of "junk." In earlier years, there were certainly aggressive and highly speculative deals with questionable business models and insufficient cash flow to service debt. However, the asset class has matured during the past 25 years and has delivered attractive risk-adjusted returns over the long run. Far from junk, it is time to change the perception of high yield bonds.

Investors face an age of increased volatility and correlations driven by a highly politicized and deleveraging world. This protracted deleveraging process in both public and private markets will weigh on global growth, and the search for income and diversification will be of utmost importance for investors. In this time of elevated volatility and high probability for tail risks, we believe the global high yield asset class provides an attractive proposition for long-term investors. Based on our analysis of historical returns, a permanent allocation in global high yield bonds can even replace an equity allocation within an overall portfolio—with the potential to decrease overall risk without sacrificing return.

GROWTH OF THE GLOBAL HIGH YIELD ASSET CLASS

The global high yield market has grown significantly over the past two decades, surpassing the U.S. high yield market. Since 2000, the asset class's outstanding value has increased by over $1.3 trillion to $2.35 trillion. The global high yield market has helped fund many well-known multinational brand names (e.g. Dole, Goodyear, Hertz,

Figure 1 Number of High Yield Issues Outside of the U.S. Continues to Grow as the Market Develops As of 12/31/2015



Sources: Bank of America Merrill Lynch, Brandywine Global Investment Management

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British Airways, and Levi's) as well as transformed specific industries (e.g. the U.S. gaming and casino market and firms like MGM, Harrah's, Sands, and Borgata). In the past several years, the market has become even more diversified, driven by the increase in high yield issuance from European and Asian companies (see **Figure 1**). The expanded and compelling global opportunity set suggests investors look more broadly to global high yield rather than limit portfolio allocations to only domestic issues.

GLOBAL HIGH YIELD MAY PROVIDE MORE ATTRACTIVE TOTAL RETURNS THAN U.S. HIGH YIELD AND EQUITIES

Over the long term, global high yield bonds have provided equity-like returns with lower volatility. The following table highlights the global high yield asset class's outperformance versus U.S. high yield and equities across multi-year periods.

Performance (%) — As of 12/31/2015

RETURN	1 YEAR	3 YEARS	5 YEARS	10 YEARS	15 YEARS	20 YEARS
Barclays Global High Yield	-2.72	1.45	5.19	7.29	8.38	8.07
Barclays U.S. Corporate High Yield	-4.47	1.69	5.04	6.96	7.59	6.75
S&P 500	1.38	15.13	12.57	7.31	5.00	8.19
Russell 2000	-4.41	11.65	9.19	6.80	7.27	8.03

Furthermore, the performance of the global high yield asset class has a significantly lower standard deviation relative to equities. As seen in the table and chart below, the standard deviation of the Barclays Global High Yield Index is consistently less than either the S&P 500 Index or the Russell 2000 Index and similar to the Barclays U.S. Corporate High Yield Index in every time period over the last 20 years (see **Figure 2**).

Standard Deviation (%) — As of 12/31/2015

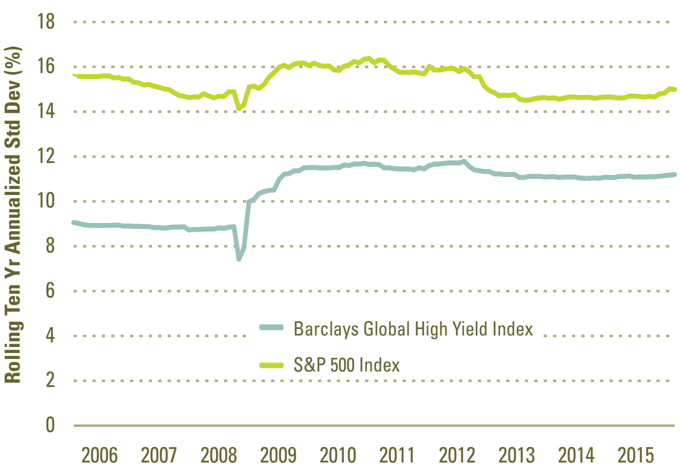
	1 YEAR	3 YEARS	5 YEARS	10 YEARS	15 YEARS	20 YEARS
Barclays Global High Yield	6.13	5.68	7.24	11.22	10.41	10.18
Barclays U.S. Corporate High Yield	6.14	5.26	6.20	10.54	9.98	9.07
S&P 500	13.08	10.47	11.60	15.00	14.97	15.29
Russell 2000	13.87	13.96	15.81	19.70	19.46	19.89

Intuitively, these results produce higher risk-adjusted performance for global high yield bonds compared to either equity index (see **Figure 3**).

Sharpe Ratio — As of 12/31/2015

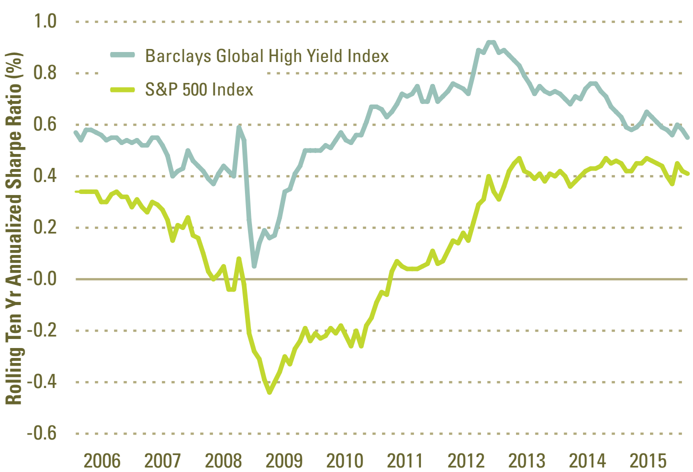
	1 YEAR	3 YEARS	5 YEARS	10 YEARS	15 YEARS	20 YEARS
Barclays Global High Yield	-0.45	0.25	0.71	0.55	0.66	0.55
Barclays U.S. Corporate High Yield	-0.73	0.31	0.80	0.55	0.61	0.48
S&P 500	0.10	1.44	1.08	0.41	0.23	0.38
Russell 2000	-0.32	0.83	0.58	0.29	0.30	0.28

Figure 2 Rolling 10-Year Annualized Standard Deviation
As of 12/31/2015



Source: Bloomberg L.P.

Figure 3 Rolling 10-Year Annualized Sharpe Ratio
As of 12/31/2015



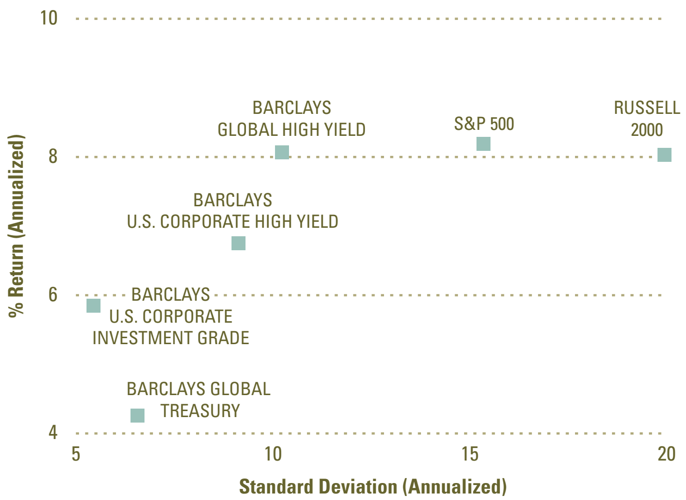
Source: Bloomberg L.P.

The global high yield asset class's attractive total return is driven by both interest income received from coupon payments and the value derived from its higher position in the capital structure. Bonds have a more senior claim to the assets of a company when compared to the claim of an equity stakeholder. The interest income (or carry) and the ultimate recovery value in the event of default protect bondholders in cyclically difficult years. Additionally, global high yield demonstrates similar total return upside capture in cyclically strong periods due to the combination of price appreciation and coupon payments.

ALWAYS AN ALLOCATION TO EQUITIES, SO WHY NOT IN GLOBAL HIGH YIELD?

Global high yield bonds offer an attractive trade-off to investors relative to both domestic high yield and equities, with a hybrid risk-return profile that combines characteristics of both fixed income and equities. The graph below shows the total return of certain indices against the standard deviation of returns for those same indices from January 1, 1990 through December 31, 2015 (see **Figure 4**).

Figure 4 Total Return of Indices vs Standard Deviation of Indices
1995-2015



Results displayed in U.S. Dollar (USD). Data Frequency Used: Monthly. Source: eVestment

During this period, the Barclays Global High Yield Index shows a relatively more attractive risk-return profile when compared to the Barclays U.S. Corporate High Yield Index, S&P 500 Index, and Russell 2000 Index. A return correlation matrix over the same period shows high yield correlations of 0.68 with the S&P 500 Index and 0.67 with the Russell 2000 Index. The correlation of global high yield bonds with the Russell 2000 Index, we think, persuasively makes the argument for an allocation to global high yield bonds as a substitute for equities.

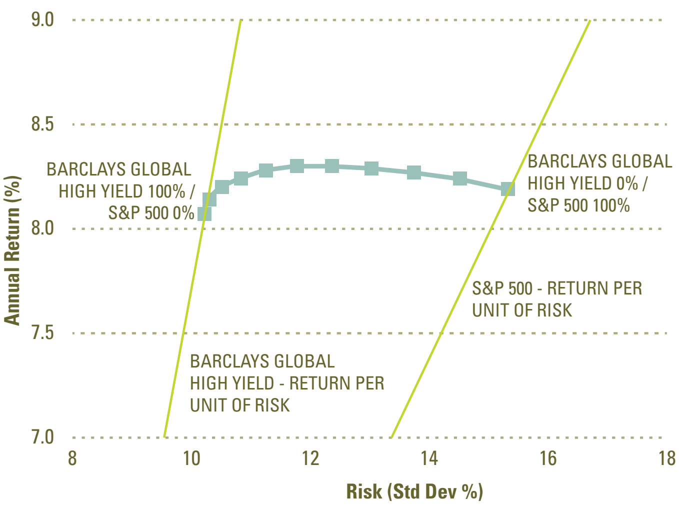
Correlation Matrix
1995-2015

RETURN	BARCLAYS GLOBAL HIGH YIELD	BARCLAYS US CORPORATE HIGH YIELD	S&P 500	RUSSELL 2000	BARCLAYS US CORPORATE INVESTMENT GRADE	BARCLAYS GLOBAL TREASURY CORPORATE
Barclays Global High Yield	1.00					
Barclays U.S. Corporate High Yield	0.93	1.00				
S&P 500	0.68	0.62	1.00			
Russell 2000	0.67	0.63	0.81	1.00		
Barclays U.S. Corporate Inv. Grade	0.53	0.53	0.22	0.16	1.00	
Barclays Global Treasury	0.20	0.13	0.06	0.02	0.54	1.00

Source: eVestment

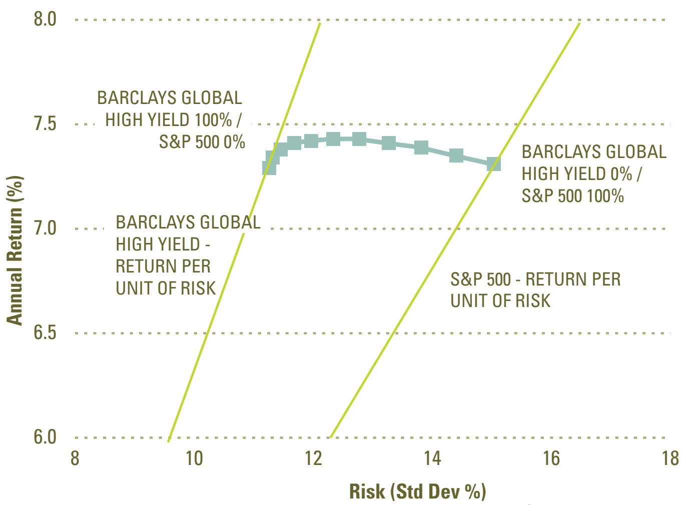
Even with the high correlation to equities, the attractive risk-return profile supports the addition of global high yield bonds within the context of an entire portfolio allocation. Typical asset allocation models include 30%–40% allocations to fixed income and 60%–70% allocations to equities. The chart below shows the effect of decreasing equity exposure and increasing global high yield exposure in 10% increments over the period of January 1995 through December 2015. When evaluated against historical results as part of an aggregate portfolio allocation, reallocating a portion of equities to global high yield bonds improves the overall risk-return profile (see **Figures 5 and 6**).

Figure 5 Decreasing Equity Exposure; Increasing High Yield Exposure
1995 - 2015



Source: Bloomberg L.P.

Figure 6 Decreasing Equity Exposure; Increasing High Yield Exposure
2005 - 2015



Source: Bloomberg L.P.

CONCLUSION: GLOBAL HIGH YIELD AS A CORE PORTFOLIO ALLOCATION

While there is a long-held belief that the high yield asset class should be used tactically in portfolio allocation, our analysis shows otherwise. We believe that an allocation to high yield—and specifically to global high yield—should be a permanent, core component of an investor's asset allocation model. Based on our research and analysis, a global high yield allocation has the potential to provide an investor with equity-like returns, lower a portfolio's volatility, improve the overall risk-return profile, and provide potential diversification benefits relative to both equities and domestic high yield. The lower risk profile of the global high yield asset class versus equities makes intuitive sense, as the bond investor's return stream is better defined than the equity investor's return stream. Bond investors earn a contractual, predefined income stream from coupon payments and, in a default situation, bond investors are senior in the capital structure. If recovery rates and loss-adjusted default probabilities remain within ranges consistent with historical experience, investors are likely to be well compensated for maintaining a permanent allocation to global high yield debt from both an absolute and risk-adjusted perspective.