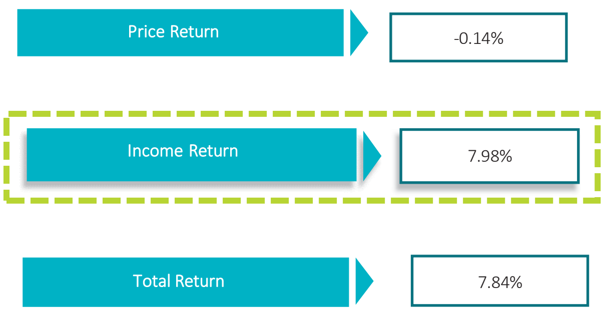
Investing in high yield bonds

High yield bonds have a reputation as being speculative and closely correlated to equities. But, we believe, there is more to this asset class, which has seen growth and maturation over the past several decades.

High yield bonds, also known as "junk" bonds, are issued by companies with a lower credit rating than their investment grade counterparts. High yield bonds typically offer investors higher income to compensate for the risk of the lower credit rating and, as such, offer investors a higher risk, higher return option than more traditional fixed income markets.

We believe that the key to achieving potential attractive returns within high yield is to compound income and avoid capital loss. As the chart below shows, average historical market returns for high yield performance is largely driven by coupon payments, with changes in price providing a negligible contribution to return. As such, we believe, our philosophy is well-suited to make the most of what the asset class can offer, while seeking to avoid its principal risk – that of companies defaulting on their debt.

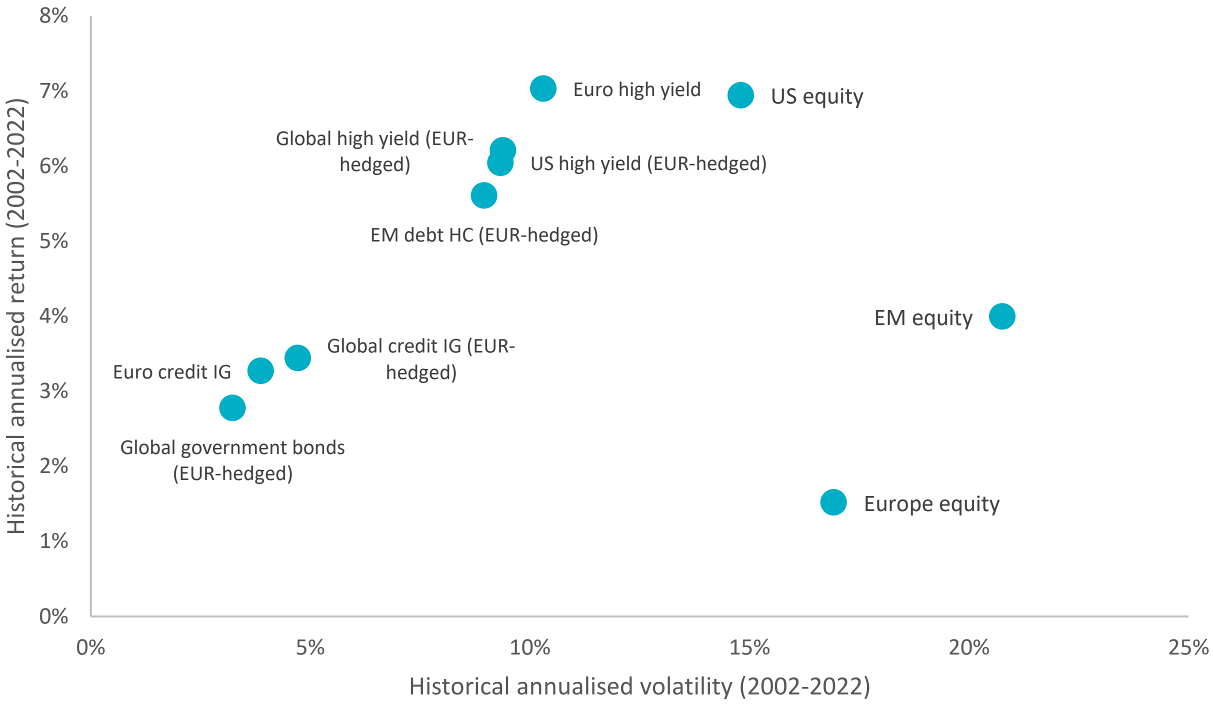
Chart 1: Average historical market return[1]



High yield bonds may form an attractive part of a wider portfolio. Chart 2 below shows the annualised return and volatility for a range of different asset classes over the 20 years to the end of June 2022. As you can see, high yield bonds have, historically, delivered lower volatility than Europe, US or emerging market equities, with higher returns than other fixed income markets. In general, while the correlation may differ depending on market conditions, investors should expect high yield bonds to be less volatile than equities .

[1] Source: AXA IM, ICE BofA Developed Markets High Yield Constrained Index (HYDC) Hedged USD, incepted 12/31/1997. Dates from 31/12/1997 to 31/12/2021. For illustrative purposes only. Past performance is not indicative of future results.

Chart 2: risk/reward profile of high yield bonds vs. other asset classes[2]



Key advantages of high yield bonds

1. Investors should benefit from high yield's attractive income stream and compound their returns over time, offering potentially higher levels of return than from investment grade and government bond markets.

2. An allocation to high yield bonds should contribute to a well- diversified portfolio. While high yield bonds are a higher-risk fixed income asset class, they are generally considered less volatile than equities

3. Investors may benefit from the potential for capital gains in high yield bonds to a greater extent than investment grade bonds. Rating upgrades or positive market developments may lead to high yield bonds performing strongly, especially during the recovery phase of the economic cycle.

4. Debt sits above equity in a company's capital structure, meaning that in the event it is listed, a company will halt dividend payments to shareholders before coupon payments to bondholders are interrupted.

What are the Risks?

Default risk: The biggest risk involved in the high yield universe is default risk, where companies fail to meet their debt obligations. While default rates picked up as a result of the pandemic, they remained relatively low compared to other periods of turbulence, such as the bursting of the dotcom bubble. High yield issuers tend to have weaker balance sheets than investment grade companies and can be hurt more by a deterioration in economic fundamentals. Over the last twenty years (including the global financial crisis and COVID-19 pandemic), the average default rate for US and European high yield issuers has been 4.06% and 3.15% respectively[3]. We believe that the key to successful high yield investing is in avoiding those companies likely to be subject to a deterioration in credit quality and therefore to avoid capital loss.

[2] Source: AXA IM, Bloomberg, ICE BofA Merrill Lynch, based on monthly returns as at 30/06/2022. Indices referred to are: ICE BofA Global Government Index, ICE BofA Global Corporate Index, ICE BofA Euro Corporate Index, ICE BofA US High Yield Index, ICE BofA Euro High Yield Index, ICE BofA Global High Yield Index, ICE BofA US Emerging Markets External Sovereign Index, S&P 500, Eurostoxx 50 & MSCI Emerging Markets

[3] Source: Default data from Moody's as at 30/06/2022. Historical data since December 2001.

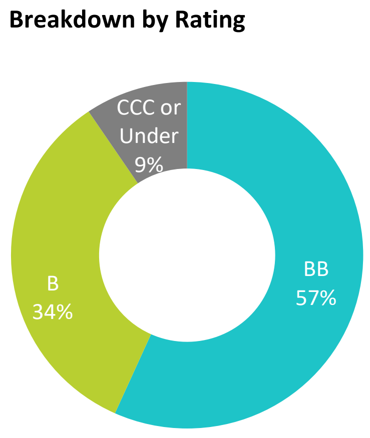
Illiquidity: High yield bonds may not have the same level of demand as other bonds which may mean they are harder to sell. This illiquidity can mean prices are more volatile than those of investment grade bonds. As with all bonds, any potential rating downgrade – threatened or otherwise – can have an impact on the price of a bond.

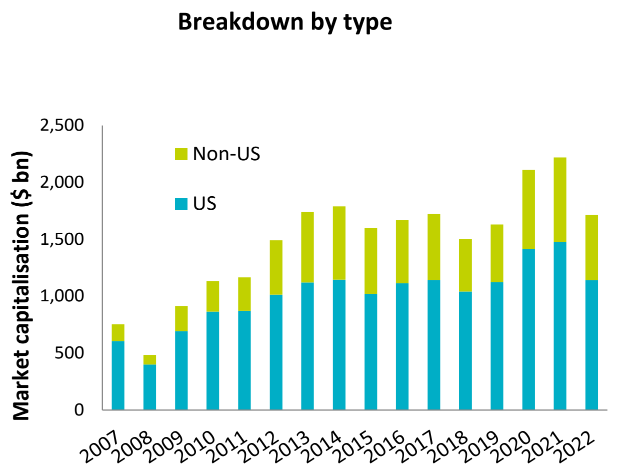
What does the global high yield market look like?

The global high yield market has grown significantly over the past twenty years, and was worth approximately $2.4tn by the end of July 2022.[4] There were more than 3500 issues, with the market having produced an average annual total return of 7.84% between 31/12/97 and 30/06/22.[5]

As at the end of July 2022, the global average linear rating was BB3 (just one notch below the lowest level of investment grade bond ratings) with a full range of industries and sectors represented[6]. Energy, telecoms and healthcare currently account for the top three sectors, with the insurance sector the smallest, accounting for just 1% of the global high yield market.[7] We believe this growth of issuers across sectors and geographies demonstrates the maturation of this asset class.

Chart 3: The high yield market by rating and type[8]





4 Source: AXA IM / ICE BofAML as at 31/07/2022
5 Source: AXA IM / ICE BofAML as at 30/06/2022 . Issue numbers as of 31/07/2022 . Market represented by ICE BofAML Global High Yield Index. Past performance is not a guide to future performance. No assurances can be made that profits will be achieved or that substantial losses will not be incurred.

6 Source: As at 31/07/2022. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

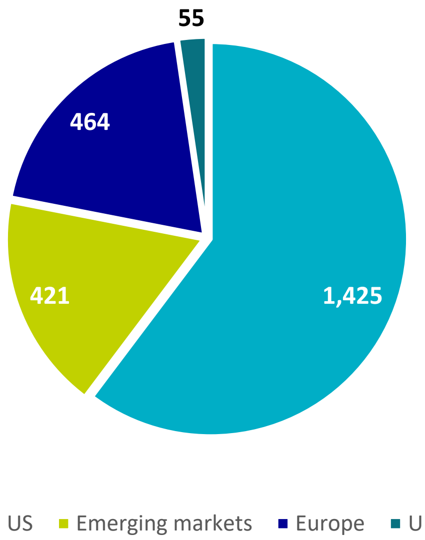
7 Source: AXA IM / Bloomberg as at 30/06/22. ICE BofA Developed Markets High Yield Constrained Index (HYDC) Hedged USD . The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

8 Source: AXA IM, Bloomberg as at 30/06/2022. ICE BofA Developed Markets High Yield Constrained Index (HYDC) Hedged USD. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

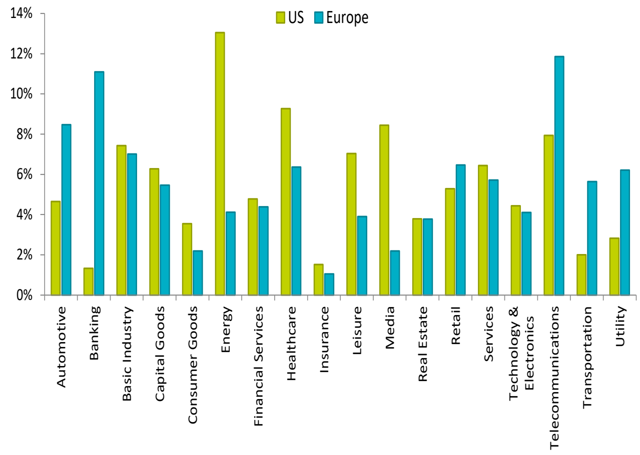
Investing by region

As chart 4 shows, the US high yield bond sector is the largest and most developed globally. However, other regions have seen significant growth in their high yield markets over the past two decades, offering investors significant choice and geographic flexibility.

Chart 4: Global high yield market value by region (USDmn)[9]



Sector Exposure*



While the US is the largest sector, the sector breakdown shows it has different exposures to that of the next largest market, Europe. The US market has much greater exposure to energy and media, while banking and automotive sectors exposure is greater in the European market. These sector exposure examples demonstrate how much variation there is across high yield markets and how they should offer investors different characteristics with which to build a diversified portfolio.

Comparing US and European high yield[10]

	US high yield	European high yield
Size of market (USD bn)	1,425	464
Number of issues	1972	781
Average rating	B1	BB3
Duration (modified to worst)	4.5	3.5
Yield (to worst)	7.72%	6.29%

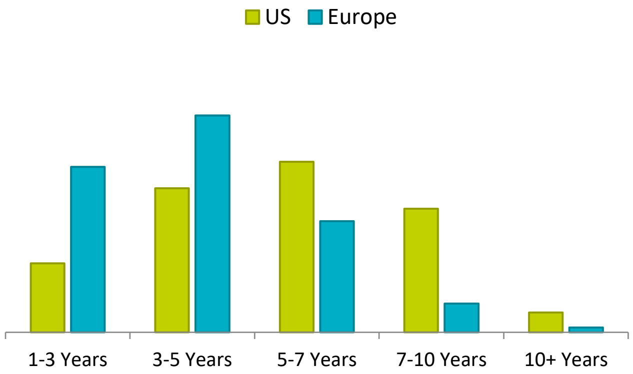
[9] Source: AXA, ICE BofAML as at 31/07/2022*Source: AXA IM, ICE BofA as of June 30, 2022. The indices shown are ICE BofA European Currency High Yield Index (HP00) and ICE BofA US High Yield Index (H0A0).

[10] Source: ICE BofAML as at 31/07/2022. Performance is shown hedged in USD. Past performance is not a guide to future performance. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

Topical strategies within high yield

Short Duration: Investors may wish to consider a short duration strategy if they are concerned about the potential for higher interest rates as shorter duration bonds tend to be less sensitive to rising interest rates. In addition, shorter-dated bonds typically exhibit lower levels of volatility and therefore a short duration strategy may be more suitable for investors concerned about allocating to a riskier asset class. Europe, historically, has tended to have a higher allocation to short duration high yield bonds although it still makes up about a third of the overall US high yield market.

Chart 5: Breakdown Maturity[11]



US high yield universe is over $1.8 trillion

Short Duration makes up approximately 1/3rd of the US high yield universe [12]

Low Carbon: Investors looking to make a positive impact on the environment can now reflect this within their high yield portfolio. The growing data available on Environment, Social and Governance (ESG) factors allows investors to assess high yield issuers on how they perform against these considerations. We have found that when it comes to impact investing, there is higher coverage of carbon and water intensity scores within the high yield universe than many other ESG key performance indicators, making these metrics well-suited to integrate into the investment process and make a tangible positive impact on climate change.

[11] Source: AXA IM, ICE BofA as of June 30, 2022. The indices shown are ICE BofA European Currency High Yield Index (HP00) and ICE BofA US High Yield Index (H0A0). The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer. For illustrative purposes only.
[12] Source: JP Morgan Credit Strategy Weekly Update, data as at 26 June 2020. Note for illustrative purposes only.