Case For
Global High Yield

2021

The Case For Global High Yield

Why Now, Why Indexing

- Attractive risk/reward characteristics
- Diversification benefits
- Structural changes now favour indexing

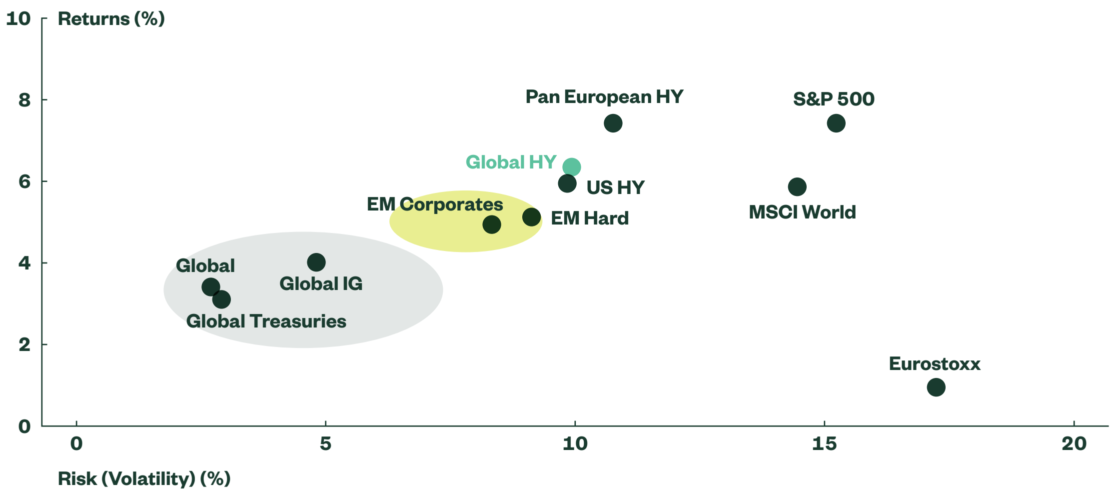
The attractive risk/reward characteristics of high yield bonds mean they continue to gain traction with investors. Their combination of higher yield and lower duration is a sought-after feature in the current low-yield environment.

And, when compared to other fixed income sectors, high yield's diversification benefits sets it apart from the poorly rewarded duration and credit risks of today's core sovereign and investment grade bond markets. Its defensive qualities — that have consistently led to lower drawdowns relative to equities — boost the sector still further.

Attractive Risk/ Reward Profile

An important part of high yield's attractiveness hinges on its long-term ability to deliver equity-like returns for comparatively lower levels of risk. While high yield has been riskier than high-quality sovereign and corporate bonds, the asset class's defensive qualities of high coupons and relatively short duration provide support at this stage of the investment cycle.

Figure 1
Risk/Reward Profile 15 Years — EUR Hedged



Source: State Street Global Advisors, Bloomberg as at 28 February 2021.

Figure 2
Correlation of Global High Yield Returns Over the Last 15 Years

Global Treasuries	-0.13
Global Agg.	0.19
Global Corporates	0.69
US High Yield	0.99
EUR High Yield	0.93
EMD Hard Currency	0.82
S&P 500	0.74
Euro Stoxx	0.71

Source: State Street Global Advisors, Bloomberg as at 28 February 2021.

After the Storm, Comes the Calm

High yield is not without its periodic risks: The turbulence of the 11% yields and 7% defaults experienced during 2020 in US high yield were a very timely reminder of those. But with yields on US high yield dipping below 4% recently, this volatility and distress all seem like a distant memory. For high yield investors that had to navigate the choppy waters of 2020, the current environment of tight spreads, low distress and ample liquidity are to be welcomed.

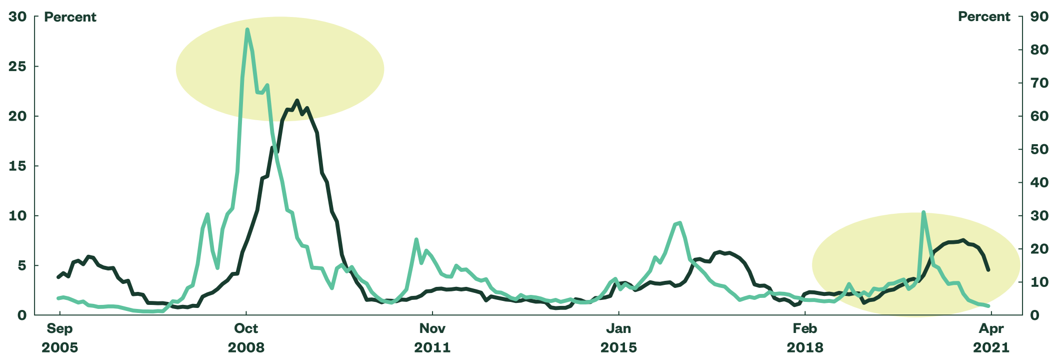
And, with the credit cycle as arguably the most important driver of overall high yield market performance, investors have experienced a very sharp V-shape recovery in almost every high yield credit metric.

This current strong cyclical upswing is underpinning credit fundamentals globally. High yield markets have made a rapid recovery from the critical state when the pandemic hit in March 2020. The vital signs of high yield health are all flashing green today — from spreads, distress ratios to funding availability — leading to improvements in market liquidity and investor flows.

Default Outlook Benign

Default risk is key in high yield investing, as it not only causes credit losses, but also drives sentiment and therefore spreads and ultimately performance. A key leading indicator of future default rates is the distress ratio within the high yield universe. As the chart below shows this has declined from close to 30% last year to less than 4% currently. This suggests that the turn in the default cycle has already occurred last year and that future defaults are expected to remain subdued — in very low single digits — over the months and quarters ahead.

Figure 3
US High Yield Market — Distress Ratio



Source: BofA Merrill Lynch Global Research, State Street Global Advisors. Data as of 31 May 2021.

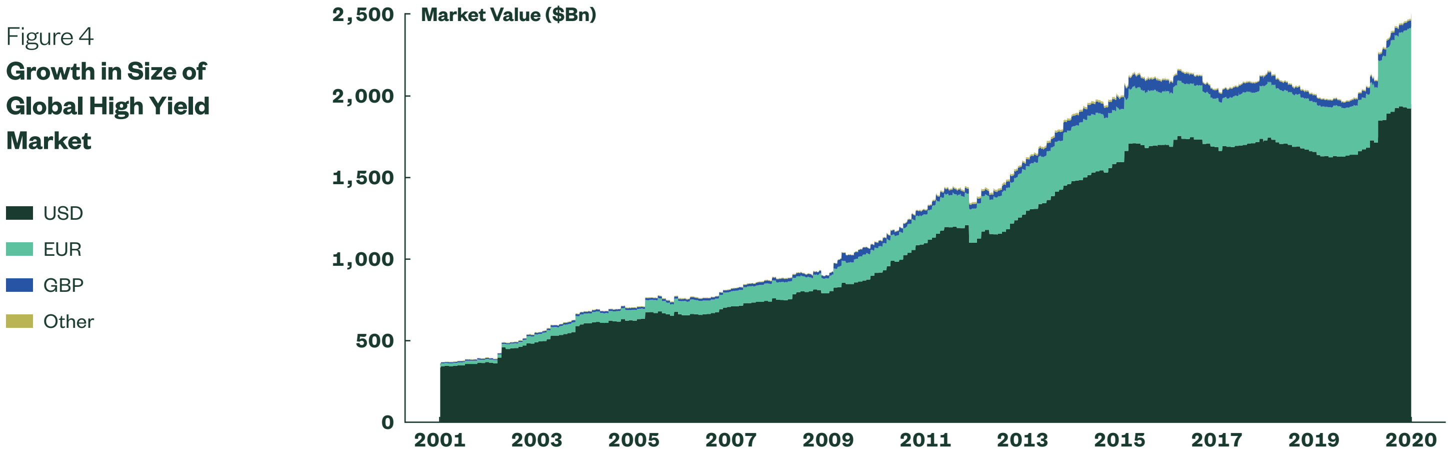
This initial repair and now recovery phase of the credit cycle can persist for several years and is usually a relatively good period for high yield returns. It is generally a period when the additional spread of high yield bonds can be earned quite consistently.

While the exceptional returns from spread tightening may be behind us, the more stable income- or carry-driven returns can still be earned consistently. This phase of the credit cycle will be boosted this time around by the broad cyclical upswing underway which in turn will drive credit upgrades, which we believe will keep high yield markets well supported over the medium-term horizon of the next couple of years.

Impact of Pandemic on the Structure of High Yield Market

The global high yield market now stands at over $2.5 trillion in size, across 1,500+ borrowers of which 22% are non-USD. There have been some long-term structural changes underway for some time in global high yield, and the graph below illustrates the growth in this market both within and outside the dominant USD market.

Figure 4
Growth in Size of Global High Yield Market

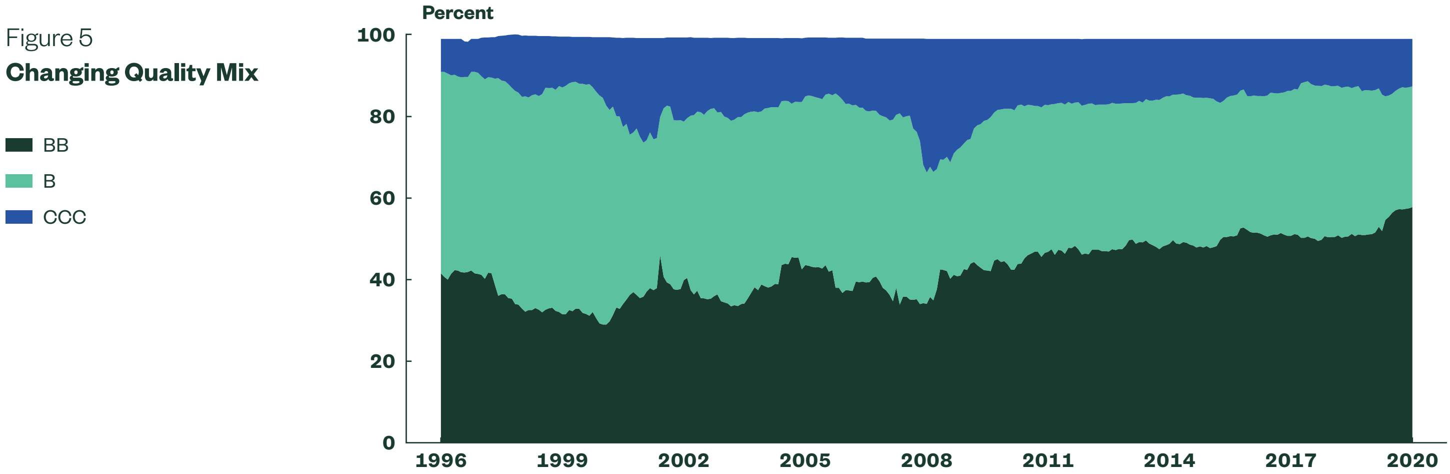


Source: BofA Merrill Lynch Global Research, State Street Global Advisors. Data as of 31 December 2020.

Improving Quality Mix

The pandemic has also left a significant mark on the structure of the high yield market. Last year's combination of record fallen angels ($270bn or 10%) and high defaults (7%) has now bolstered the quality mix of high yield. In fact, BB's now make up over 55% of the global universe.

Figure 5
Changing Quality Mix



Source: BofA Merrill Lynch Global Research, State Street Global Advisors. Data as of 31 December 2020.

Return of the Angels

Recent optimism around growth and reflation has already accelerated the thinking around the timeline for healing balance sheets and eventual upgrades.

The speed of the COVID-19 shock and the sharp V-shaped recovery that is taking hold, are likely to enable rating profiles to improve faster in this cycle and the spread normalization of these fallen angels that has happened faster than in previous cycles supports this.

For European bond investors, we recommend the global high yield universe as the best exposure given its breadth and allocation to the largest and deepest market, namely the US, as well as the growing European market. However, in order to isolate the credit returns, currency risk needs to be hedged. Thankfully today that cost of hedging is quite low, such that European investors can harness the additional yield and spread of the US market very effectively.

Active High Yield — Unfulfilled Expectations

Traditionally, high yield investors have considered active management to be the best way to access the market, due to the information inefficiency and lack of transparency of the market, along with the expectation that active managers can anticipate downgrades and identify and underweight out-of-favour sectors.

However, in today's market — in which price discovery, liquidity and transparency have improved significantly — active managers have had difficulty adding value over their benchmarks. In fact on a net-of-fee basis, our research on the US high yield universe shows that the vast majority of managers, regardless of style and size, have consistently failed to outperform their benchmarks over annual and longer-term time periods. The chart below shows that gross-of-fee excess returns have been on a consistent downward trend over recent years.

Figure 6
Average Excess Returns of Active US High Yield Managers (Ex-Short Duration and Gross of Fees)

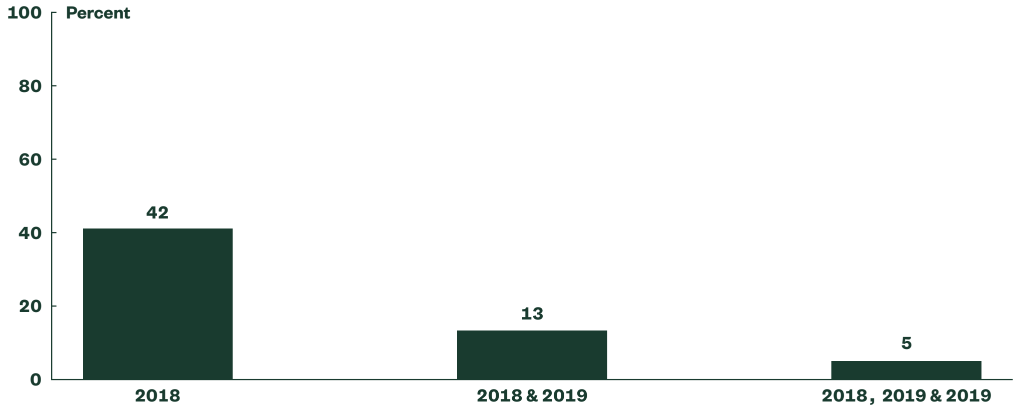
Source: eVestment. As at 31 December 2020.

In addition, it appears that given the predominantly defensive styles of active managers, they also fail to capture the full return potential of the market, particularly during cyclical recoveries, that are typically the strongest periods for high-yield returns. While this may be justified on style grounds, it is a cause of underperformance in the long run nonetheless, and may also explain the lack of persistency in manager performance.

In order to investigate the persistency issue further, we have isolated those managers who outperformed their respective benchmark for each of the past three calendar years (next page).

The results clearly show that it has been exceedingly difficult for active high yield managers to maintain their strong performance, with only 5% of managers able to outperform their benchmarks for each of the last three years.

Figure 7
% of Strategies Outperforming in Consecutive Years, Net of 40 bps Fee



Source: State Street Global Advisors, eVestment as at 31 December 2020.

These results are also corroborated by the 2020 S&P Dow Jones Indices US Persistence Scorecard, which showed that only 10% of managers remained in the top quartile for the three consecutive years since 2018.

Alpha Generation More Elusive

As well as the improvements in high yield market liquidity and transparency, there has also been a proliferation of new market participants generating greater competition for trades that can deliver alpha. With many of the inefficiencies that originally attracted active managers to high yield now gone or significantly reduced, alpha generation has become more elusive. According to the eVestment High Yield Universe, the number of active high yield strategies has increased by 340% over the last 25 years (below).

Figure 8
Increase in High Yield Strategies and Issuers

	1996	2000	2010	2020
Number of Strategies in eVestment US High Yield Universe ex Short Duration	66	132	226	224
Number of Issuers — ICE BofAML US High Yield Index	500	713	1,012	860

Source: State Street Global Advisors, eVestment as at 31 December 2020.

The above figures only reflect dedicated institutional high yield strategies and do not reflect the increase in the number of high yield retail mutual funds and hedge funds, as well as fixed income strategies such as Core Plus and Multi-Sector that allocate to high yield.

During this period, the growth in the number of companies issuing high yield bonds hasn't kept pace at all, growing from 500 in 1996 to 860 at the end of 2020. The number of issuers in the high yield market will fluctuate, due to upgrades/downgrades or defaults.

However, over the last twenty years the number hasn't changed that dramatically. The end result is, that compared to two decades ago, today's active high yield management space is crowded and affords less ability for managers to distinguish themselves by engaging in unique value-add trades.

High Yield Indexing – A Reliable and Cost-Effective Alternative

In contrast, fixed income indexing has developed tremendously in sophistication, scope and delivery in recent years, allowing investors to gain exposure to parts of the market previously considered too difficult for indexing. Investors are finding they can get the exposure they need to almost any fixed income sector without the added cost and complexity associated with selecting, evaluating and understanding active management. Given the high costs and performance challenges of active, investors are now rethinking how best to harness the full return potential of high yield markets.

The strong growth in global high yield bond markets has brought about the important structural and liquidity changes mentioned above that have improved both transparency and price discovery. ETFs have played a vital role in transforming high yield market liquidity and flow dynamics in recent years. Innovations in trading, such as portfolio and completion trades, as well as enhancements to cost and risk management and all the other sophisticated indexing techniques, have all combined to make indexing in high yield a viable and attractive option for investors today.

We have also witnessed a change in the nature of how defaults are occurring; companies are increasingly choosing to do voluntary restructurings so as to avoid the protracted and expensive process of Chapter 11 in the US. This can remove another former advantage of active approaches, as investors choose to participate in these distressed exchanges and restructurings at the predetermined conditions.

At State Street Global Advisors, we have been managing indexed high yield strategies since 2004. Since then we have been continuously developing a variety of techniques that look to control risks and costs very tightly, and to then take advantage of high yield market inefficiencies that can add incremental value.

These developments have helped pave the way for us to reliably and cost-effectively deliver the full return potential of a variety of high yield benchmarks, from liquid to broad, short maturity to full maturity, as well as USD and EUR to Global.

While this journey started out with ETFs, today we are seeing increasing interest from a variety of institutional investors for indexed high yield strategies as they look to simplify and drive efficiencies into all aspects of their fixed income program.

Case for Indexed Global High Yield

Current conditions are supportive of high yield returns with the asset class usually performing well in improving economic conditions. Furthermore, with USD hedging costs now quite low the breadth, depth and higher yield and spreads available in the US market can be captured effectively for European based investors today.

With a clear case for the asset class, consideration then moves to the approach. With 95% of active global high yield managers struggling to consistently add value, net of fees, we believe that indexing in high yield is a more effective way to harness the full return potential of the sector.

Investors are now realizing that they can get the high yield exposure they need without the added cost and complexity associated with selecting, evaluating and understanding active management.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigour
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with over US $3.59 trillion* under our care.

* This figure is presented as of 31 March 2021 and includes approximately $60.33 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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