

---

# A CAUTIONARY TAKE ON HIGH-YIELD BONDS

Jeremy Schwartz — Global Head of Research

02/26/2019

On the last “Behind the Markets” podcast, Liqian Ren and I hosted two recurring guests. Bill Stone, CIO of Avalon Advisors, discussed joining Avalon and his global market outlook. Martin Fridson, CIO of Lehmann Livian Fridson Advisors, joined for the second half of the podcast to share his expertise on the high-yield bond market.

## Stone’s Experience and Market Outlook

Avalon Advisors is based in Texas, and Stone has a more positive view on some of the major energy companies. Stone favors integrated oils, which have shown greater earnings, even as oil prices declined amid a broader sell-off in late 2018. The worst-performing sector over the past decade could be headed for a rebound.

Stone is looking past disappointing recent retail sales data and believes that strong job and household spending reports will remain, while the confusion over the December retail sales data will fade.

Stone, Ren and I agreed that an impending trade deal between the U.S. and China has been about 90% priced into the market. Although there is still a risk there won’t be a deal, President Trump’s concern for the U.S. stock market and the Chinese government’s concern over its economy will likely lead to an agreement.

In emerging markets, Avalon has increased exposure to Vietnam as a growing economy that would only be bolstered by the benefits of a trade deal.

Discussing [factor](#) strategies, Stone recognized problems in portfolio construction that are brought on by [low-volatility](#) tendencies to become heavily weighted in specific sectors and their rotation to other factors. Furthermore, Stone discussed how valuations on low-volatility stocks today tend to be in slower-[growth](#) and higher-multiple stocks.

## Fridson on the High-Yield Bond Market

Following last year’s sell-off in the high-yield space, there has been a snapback in high-yield [spreads](#) so far in 2019. This has made it extremely difficult for high-yield investors such as Fridson to find value.

Fridson heavily relies on a [risk premium](#) model and the yield spread over [default risk](#) free [Treasuries](#) for taking the risk of holding [junk bonds](#). He bases this on the [ICE BofAML US High Yield Index](#). Using this model, he sees current spreads as two [standard deviations](#) below his prediction, an extreme overvaluation. Fridson attributes this to the rebound in confidence this year and the decreasing supply of high-yield paper over the past several years.

Another interesting development in the non-[investment-grade](#) market is the positive-sloping [yield curve](#). Traditionally, investors get higher premiums for shorter-dated instruments, but this situation has arisen from the lack of concern over default risk. Fridson highlighted the complacency that exists within the market for the lack of a negative yield curve.

[BBB-rated](#) bonds increasing from a third to half of all investment grade-issued debt over the past decade is another development that could affect the high-yield space if there are more [fallen angels](#) during the next market downturn. Fridson believes the situation is not as dire as the media often portrays, particularly because many insurance companies that hold these bonds are not such forced sellers and take the time to remove non-investment-grade funds from portfolios.

Please listen to our full conversation with Stone and Fridson below.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## DEFINITIONS

**Factor** : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

**Low Volatility** : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Spread** : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**Risk premium** : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

**Default Risk** : The risk that an issuer will be unable to make the payments on its debt necessary to satisfy its financial obligation to the investo.

**Treasury** : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Junk Bond** : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of 'BB' or lower by Standard & Poor's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

**ICE BofAML US High Yield Index (H0A0)** : The ICE BofAML US High Yield Index tracks the performance of the universe of US dollar denominated below investment grade corporate debt publicly issued in the US market.

**Standard deviation** : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**Investment Grade** : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

**Yield curve** : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**BBB-** : Standard & Poor's credit rating that implies the borrower has adequate capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating represents the lowest level of investment-grade.

**Fallen Angels** : A bond or issuer that was given an investment-grade rating but has since been reduced to junk bond status due to weakening financial conditio.