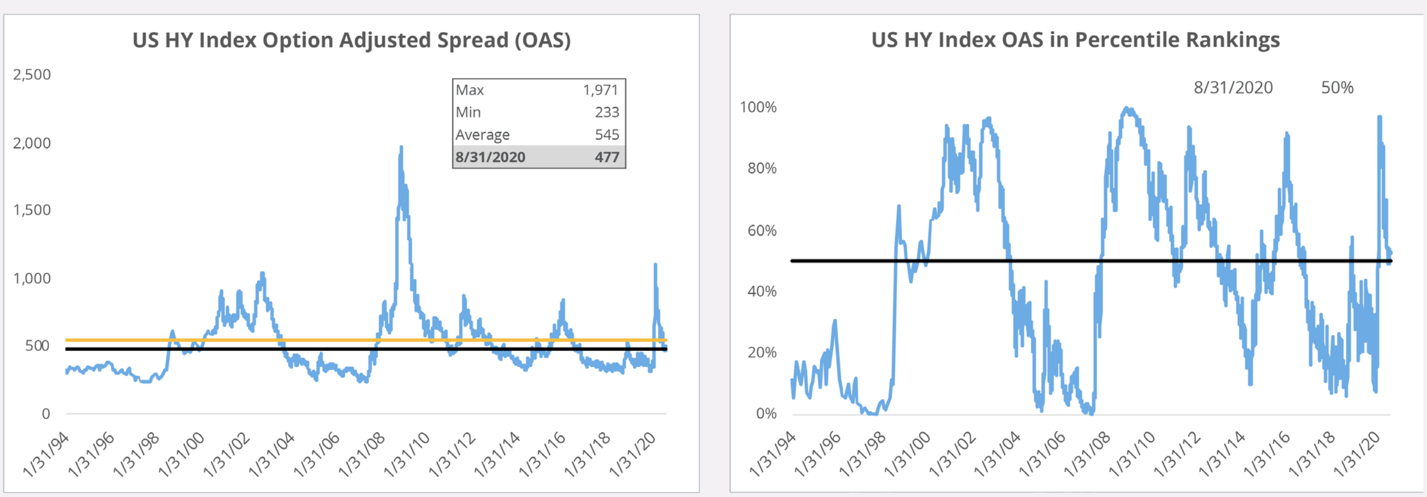
Are Current Markets an Opportune Entry Point into High Yield?

Following the COVID-19 pandemic, interest rates have dropped significantly. Income is getting harder to find, often leading investors to search for it in places where the risk is not justified by the reward. One area where investors may find income is the high yield space.

When investing in high yield, it's important to remember that the high yield market is roughly 1/5 the size of the investment grade corporate market at just over $1.4 trillion*. While it is true that most high yield rated issuers carry more debt on their balance sheet relative to their investment grade peers, there can be idiosyncratic reasons like simply being smaller that make them high yield instead of investment grade rated. For example, some of the high yield issuers we invest in are household names you'll recognize like Netflix, Dell, Ball Corporation, Hanes brands, Kraft-Heinz and Goodyear Tire, just to name a few.

To track where high yield valuations are, we monitor the option adjusted spread of the overall market as one of the many guideposts we look at. This spread measures the additional compensation an investor receives relative to various points on the risk-free Treasury curve—compensation for taking high yield risk. As you can see, spreads are relatively in line with their historical long-term average, providing plenty of opportunities for disciplined investors seeking quality issues through exploiting inefficiencies in the market. Despite the average spread levels, the COVID-19 pandemic continues to create areas of dislocation within the market through rating downgrade activity, rising default rates and increasing leverage. An independent discerning high yield research process that focuses on quality and employs stress testing to understand the underlying liquidity of issuers and their projected cash flows is able to identify plenty of successful investment opportunities in such an environment.

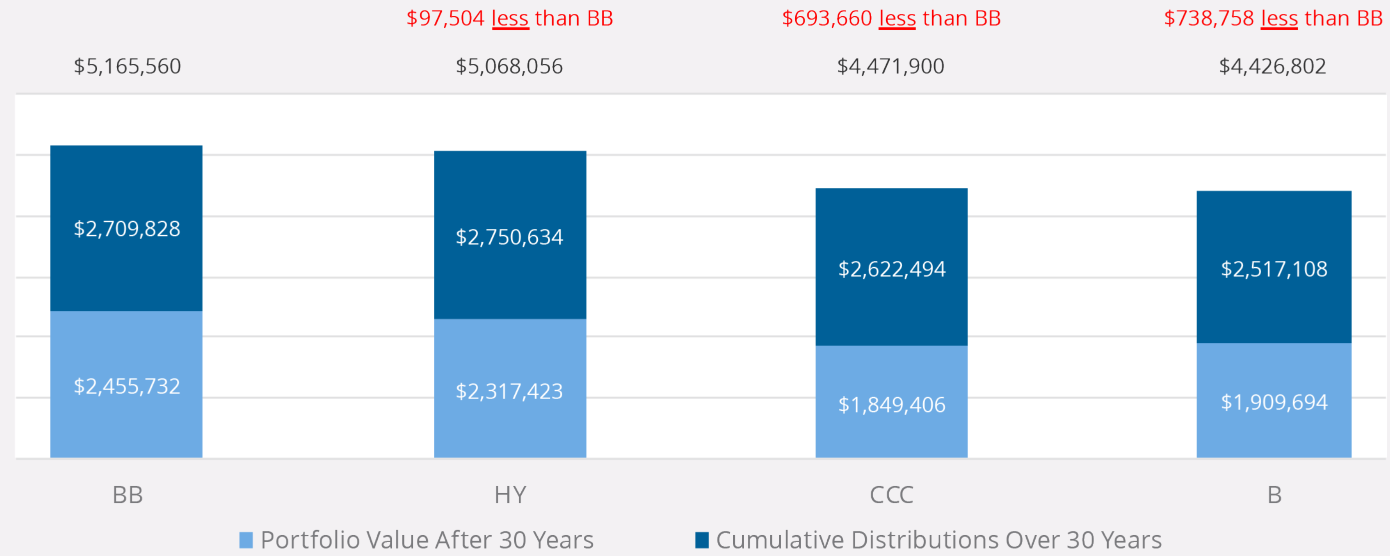
High-Yield Valuations



Source: Bloomberg Barclays Indices. Data series from 1/31/1994 to 8/31/2020.

While opportunities abound in high yield, we believe it is critical to keep in mind that quality has to be the focus when investing in this space. Our philosophy within the SBH Quality High Yield strategy is grounded in the pursuit of quality – really the bedrock of all the fixed income strategies at SBH. We define quality using a proprietary bottom-up research process instead of relying on consensus or rating agencies.

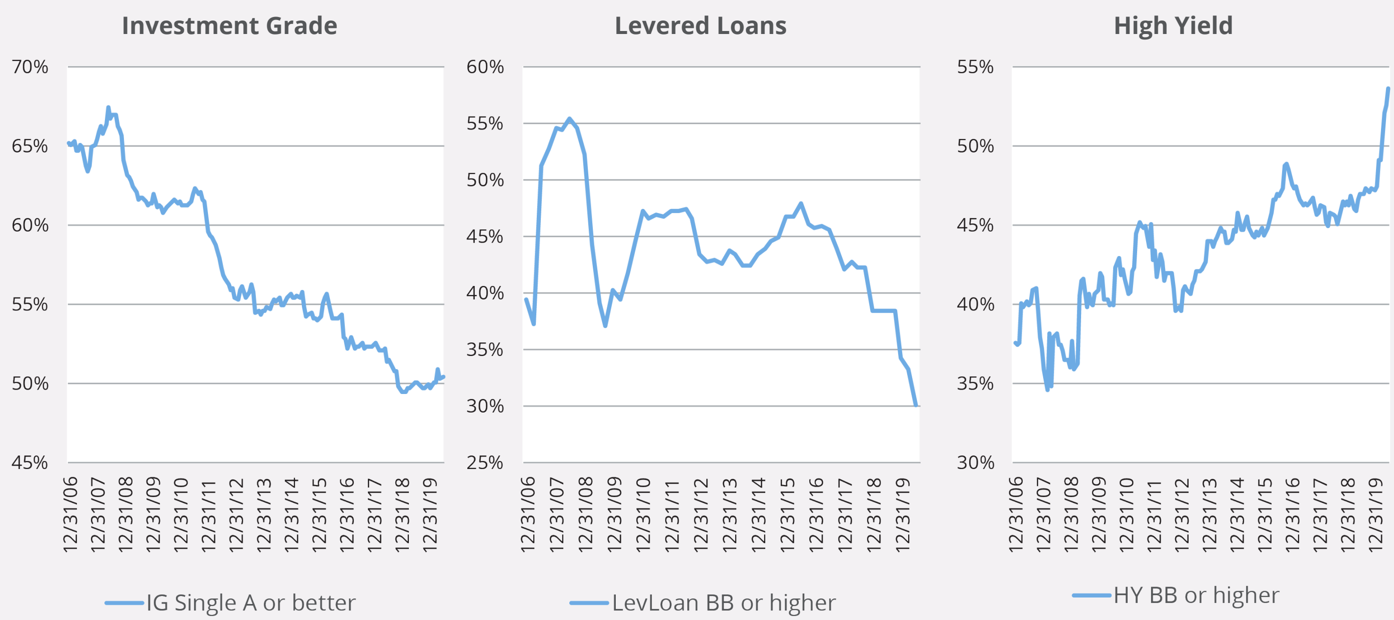
A Quality Focus Historically Has Led to the Best Long-Term Value



Source: Bloomberg Barclays. As of 6/30/2020. Historical performance cannot guarantee future results. "High quality high yield" is defined as the BB segment of the high yield market, as determined by the Bloomberg Barclays High Yield Index. Methodology: An illustration of the growth of a $1 mm initial investment in the various Bloomberg Barclays High Yield Indices, starting on 6/30/1990 and ending on 6/30/2020, assuming an annualized 5% withdrawal rate.

Also worth noting is that for the last decade plus there has been a divergence in credit quality trends across different corporate credit markets. The high yield market stands out favorably as it has tiered up in quality (defined as an increasing percentage to its top rating category) while the investment grade corporate market and levered loan market have both decreased in credit quality when looking at credit rating composition.

Quality Trends Diverge



Investment Grade and Levered Loan markets have seen the highest quality part of the markets shrink while it has actually grown in High Yield

Source: Bank of America; as of 6/30/2020. From left to right: ICE BofA US Corporate Index, S&P/LSTA Leveraged Loan Index and ICE BofA US High Yield Index.

Exploiting Inefficiencies in Fixed Income

Across environments, we also see plenty of inefficiencies in the fixed income markets that are often exacerbated during times of extreme stress.

Boiling these down into 3 key points, we seek to take advantage of the market by exploiting:

1. Rating agency misclassifications.
2. Investing in small issues rather than the higher beta large issue space.
3. Utilizing our in-depth credit research process which has helped us pick winners and avoid losers.

In terms of ratings misclassifications, our credit analysts cover CCC up to AAA rated companies as we believe this best positions us to identify the friction point between investment grade and high yield markets. Current markets have seen plenty of what are called "fallen angels"—or companies that have transitioned from investment grade to high yield. Our strategy gives us access to these companies and the ability to identify those that may be positioned for a turnaround once markets normalize.

Every issuer we consider has to pass our credit underwriting process, including stress testing. On the other hand, to be included in the index's top companies, they just have to issue a lot of debt. The risk there is when markets turn, you're left with exposure to companies with a great deal of debt.

To avoid blowups, we research how companies have navigated historical downturns and evaluate them on whether it may be different in the future. In good markets, it can sometimes be easy to forget that it could be difficult to refinance your debt when times are tough. By employing disciplined credit underwriting and understanding what stress scenarios issuers can endure in the future, we gain confidence that our issuers will have the ability to manage through the tough times.

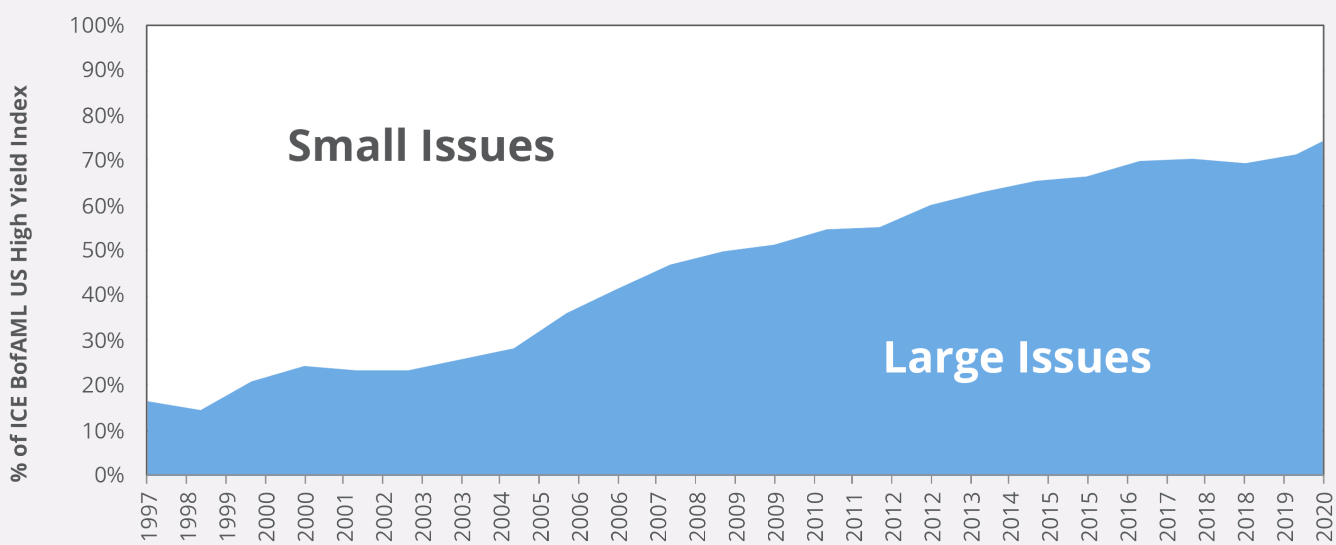
The SBH Difference

Another area where we attempt to exploit market inefficiencies is by identifying overlooked issues, particularly smaller issue sizes. Bond ETFs and many large bond managers focus almost exclusively on large bond issues. But small issues aren't necessarily small companies. Many issuers don't need a lot of debt, or simply don't come to the market frequently. When we look at what has happened to small issues in periods of market stress, it shows how much better small issues have performed versus large issues during fraught times.

While Large Issues Dominate Space, Small Issues Have Outperformed Over Time

Large Issues Dominate the Space

As of June 30, 2020



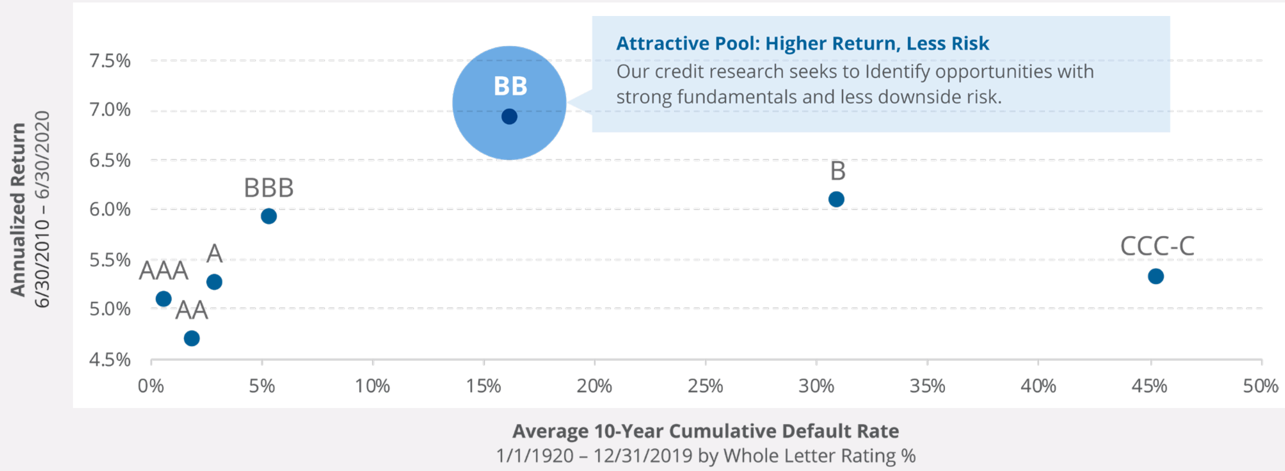
SBH's size allows us to provide our clients with meaningful exposure to small issues ($500M or less), while this is more difficult for larger money managers and ETFs.

Source: ICE BofAML Indexes, Segall Bryant & Hamill. Large issues are defined as greater than $500M. Historical performance cannot guarantee future results.

Exploiting these inefficiencies, while not sacrificing quality, leads to a unique portfolio compared to the broader high yield market. Our differentiated solution's quality focus is demonstrated by our ratings composition, with an emphasis on BB, which has historically delivered higher return with less default risk than lower rated bonds in the high yield universe.

Example of Market Inefficiencies

Searching for Optimal Risk/Reward Payoff



Source: ICE BofAML Indexes and Moody's Investors Service Global Credit Research. Data represents entire fixed income market based on the data sources listed. Data is for the periods ending 6/30/20. Historical performance cannot guarantee future results.

This has allowed our strategy to deliver consistently strong risk adjusted returns over time and historically low drawdowns versus the index. In the end, we never truly know what may transpire in the world. For this reason, a fixed income strategy should be resilient and serve investors in both good and bad markets.

To learn more about Quality High Yield at SBH, visit www.sbhic.com

Portfolio Managers - working together since 2008

Troy Johnson, CFA®

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Co-Portfolio Manager of the SBH Quality High Yield Strategy

27 years of industry experience

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Principal, Senior Portfolio Manager

Co-Portfolio Manager of the SBH Quality High Yield Strategy

19 years of industry experience

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** As of 06/30/20.*

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