Performa Market Perspective

December 2018

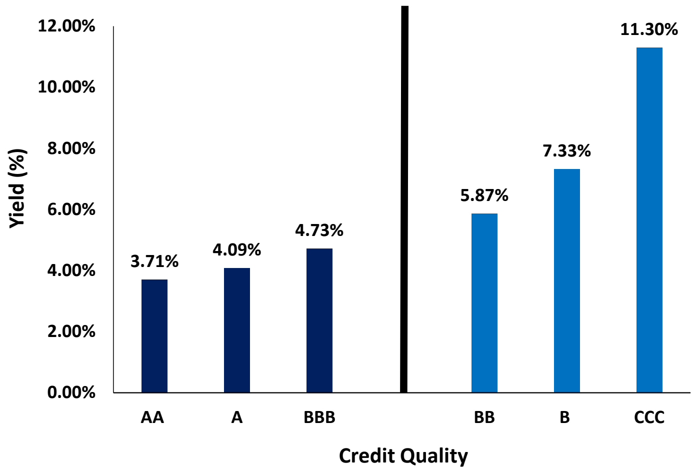
High Yield Bonds – A Critical Component Within Captive Insurance Portfolios

Over its almost 40-year history, high yield bonds have evolved from a niche corner of the fixed income market to a fully mature sector utilized by many investors. However, even with a total outstanding value over $1.2 trillion, the high yield market seems to elicit more love/hate posturing than almost any other sector. Perhaps by virtue of its hybrid nature – looks like a bond but acts like a stock – high yield bonds will always collect groups of naysayers with an opposing view. Whether it's an argument that high yield bonds do not yield enough or how they will react to future economic and broader market conditions, it seems the haters are entirely more vociferous. While other investor types may have their own assessment of the high yield market, Performa views the asset class as an integral part of captive insurance portfolio asset allocation. Early stage captives should view high yield bonds as the next logical step once surplus accumulation begins. Meanwhile, those entities with significant surplus should be availing themselves of all high yield has to offer as a tool to manage portfolio risk between traditional investment grade bonds and more volatile equity exposure.

High Yield Characteristics

In form, high yield bonds are similar to investment grade corporate bonds that are a staple in many captive portfolios. In purpose and structure, both markets exist to lend money to companies for a variety of uses. The differences, however, are the risks and returns that bondholders assume and expect. High yield issuers have lower rated creditworthiness (below BBB ratings level) and subsequently pay higher yields to investors (see Chart 1).

Chart 1: Yield to Maturity by Credit Quality Tier



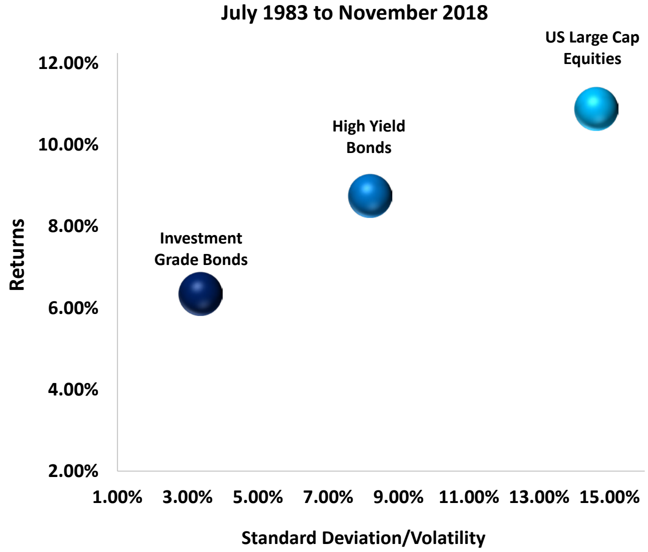
Source: Bloomberg as of 11/30/2018

The consequence is that the high yield market provides a more idiosyncratic return to investors; performance is impacted more by individual issuers and certain sectors rather than the direction of interest rates and corporate bond spreads relative to U.S. Treasury bonds.

A Sprinkle Of Equity Risk A Day Keeps Some Interest Rate Risk At Bay

Given that high yield bonds trade primarily on credit risk (as opposed to interest rate risk), the sector can provide diversification benefits when coupled with other bond and equity strategies. For a captive that is beginning to take on more risk, an allocation to high yield bonds can provide an equity-like return, but with less volatility, while diversifying away from interest rate risk. For a mature captive with multiple asset classes, high yield can provide a middle ground between investment grade bonds and equities from a risk and return perspective (see Chart 2).

Chart 2: Risk/Return Comparison
July 1983 to November 2018



Source: eVestment

Diversification is a sizable benefit, as is the ability to use a high yield allocation as a tool when adding or reducing overall portfolio risk. In either case, the diversification comes from less correlation (movement in tandem) between credit risk and interest rate risk. Roughly 35 years of data demonstrates that high yield exhibits low correlation (between 50% and 60%) to investment grade corporate bonds and equities (see table below). As for interest rate risk, high yield barely follows as its correlations to U.S. Treasuries and Government bonds are less than 10%.

Correlation of Returns - July 1983 to November 2018 Annualized

Asset Class	Benchmark	High Yield
1) High Yield Bonds	Bloomberg Barclays US Corporate High Yield	1.00
2) Corporates	Bloomberg Barclays US Corporate Inv. Grade	0.53
3) Interm. Bonds	Bloomberg Barclays US Interm. Govt/Credit	0.26
4) Treasuries	Bloomberg Barclays US Interm. Treasury	0.04
5) Government	Bloomberg Barclays US Government	0.08
6) US Large Cap	S&P 500	0.58
7) US Small Cap	Russell 2000	0.60

Source: eVestment

While diversified risk is good, it is only useful if returns are commensurate. Indeed, from July 1983 to November 2018 high yield has produced annualized returns of 8.75%, which was comparable to the S&P 500 and Russell 2000 returns of 10.89% and 9.03%, respectively (see table below). What is more telling however, is that over the same time period high yield posted a dramatically lower standard deviation of 8.19% compared to 14.62% for the S&P 500 and 18.82% for the small cap Russell 2000 Index. In other words, high yield has largely kept pace with equities while capturing only roughly half of the volatility (as measured by Standard Deviation).

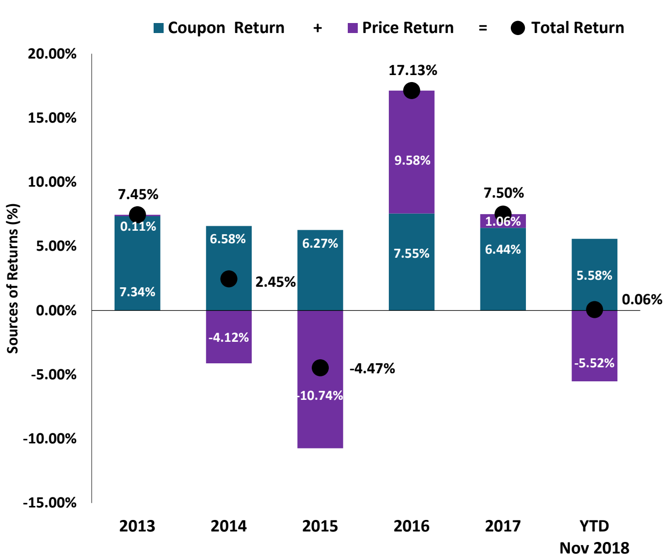
Historical Return Comparison - July 1983 to November 2018

Asset Class	Benchmark	Returns	Standard Deviation	Sharpe Ratio
1) High Yield Bonds	BBG Barclays High Yield	8.75%	8.19%	0.62
2) US Large Cap	S&P 500	10.89%	14.62%	0.49
3) US Small Cap	Russell 2000	9.03%	18.82%	0.28

Source: eVestment

The Power Of The Coupon

Bonds with higher coupons can act as a buffer for times when riskier assets (such as stocks) become more volatile or when interest rates are rising. Chart 3 illustrates how higher coupons (interest payments) can help offset negative price movements. In 2014, the high yield market fell more than 4% on a price return basis, yet its total return for the calendar year was a positive 2.45%. Since the yield of the market at the beginning of 2014 was almost 6.6%, there was more than enough income received by bond holders to offset the negative price action. Meanwhile, in 2013, the high yield price return experienced a negligible gain of 0.11%. However, a healthy coupon return of 7.34% provided investors with a total return of 7.45% for the year. 2013 was also the year in which interest rates rose across the yield curve, leading to negative total returns for several investment grade bond benchmarks. For example, the Bloomberg Barclays Intermediate US Government/Credit Index generated a return of -0.86% while the Bloomberg Barclays US Aggregate Index was -2.02% for the year.



Source: Bloomberg Barclays Live

Interest Rates On The Up And Up

Since Q4 2001, there have been 15 periods when the yield on the 10-yr U.S. Treasury had risen more than 50 basis points. During those periods of rising interest rates, the high yield market generally performed quite well, producing positive absolute total returns in 12 out of 15 instances and outperforming investment grade bonds 14 out of 15 times (see table below). Part of that has to do with rising rates being indicative of an improving economy which is usually better for lower quality bond issuers as well as stocks. Rising profitability and balance sheet improvement is especially relevant to high yield issuers as they gain greater flexibility to refinance their existing debt at lower yields and may even become investment grade credits (rising stars). Overall, a rising economy is an environment where bond defaults should remain subdued and investor demand should be supportive of spreads.

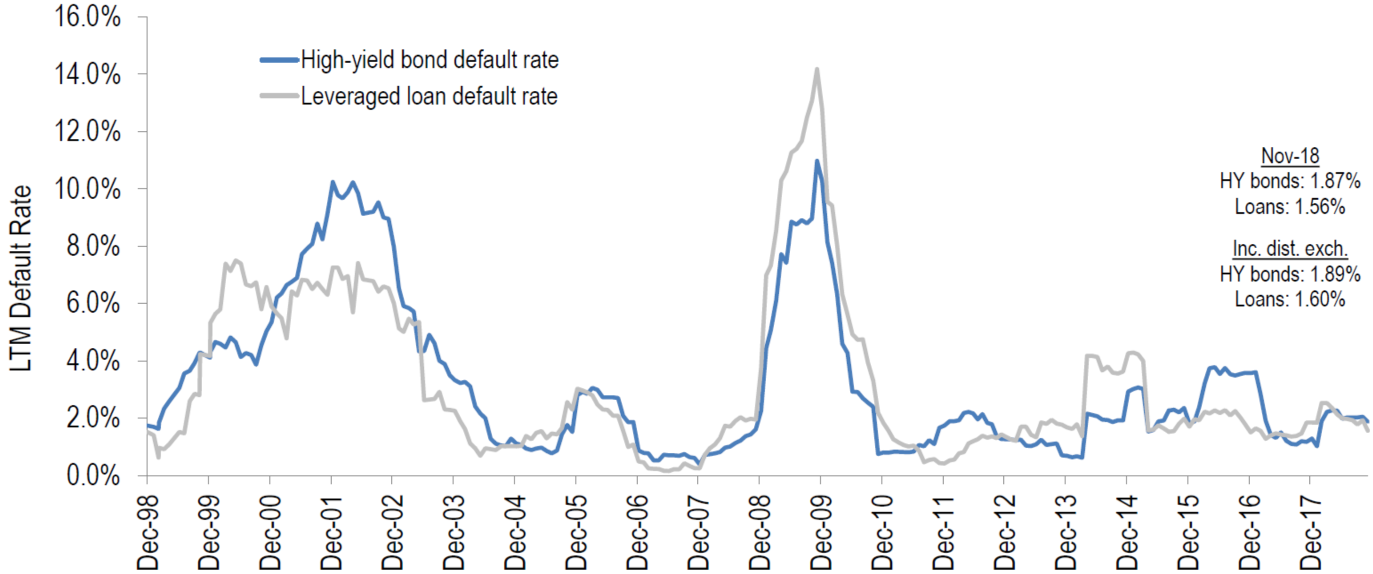
Time Period	Bloomberg Barclays Interm. US Gov/Credit	Bloomberg Barclays High Yield	High Yield Relative Performance
Oct 01 to Dec 01	-1.55%	3.22%	4.77%
Feb 02 to Mar 02	-1.52%	2.41%	3.93%
Sep 02 to Nov 02	-0.48%	5.27%	5.75%
May 03 to Aug 03	-2.55%	2.91%	5.47%
Feb 04 to May 04	-2.06%	-1.70%	0.36%
Aug 05 to Oct 05	-1.39%	-1.69%	-0.30%
Jan 06 to Jun 06	-0.16%	1.52%	1.68%
Dec 08 to Feb 09	-0.99%	2.71%	3.70%
Mar 09 to Jun 09	1.67%	23.07%	21.41%
Nov 09 to Dec 09	-1.46%	3.28%	4.74%
Aug 10 to Mar 11	-0.64%	10.46%	11.10%
Apr 13 to Aug 13	-2.50%	-1.95%	0.55%
Jan 15 to Jul 15	-0.48%	1.26%	1.74%
Jul 16 to Jan 17	-1.92%	6.09%	8.02%
Aug 17 to Nov 18	-0.88%	1.14%	2.02%

Source: eVestment

Conclusion

As 2018 comes to a close, the U.S. economy remains in its second longest expansionary period on record. Year-to-date default rates (see Chart 4 below) through November 2018 fell 0.17% to 1.87% and remain well below the long-term average of ~3.5%. Stripping out iHeart Media's $16 billion default earlier this year, the rate is only 1.14%. Leverage ratios remain in check and upgrades continue to outpace downgrades, all of which should remain supportive of credit as long as company earnings stay upbeat and the economy continues to chug along for the next few years.

Chart 4: High-yield bond and loan default rates



Source: J.P. Morgan.

The high yield market should continue to benefit from muted new issue supply as a large portion of the new issuance market is either refinancing existing debt or refinancing into the high yield loan market. While there will always be cyclicality in prices and yields across bond markets, and in the high yield bond market in particular, the sector has proven throughout multiple cycles that it should be an integral part of a client's asset allocation strategy. An actively managed high yield bond portfolio that seeks to preserve principal by managing credit risk can provide good diversification and low correlation amongst other fixed income and equity strategies. Additionally, the sector provides attractive risk adjusted returns and lower sensitivity to changes in interest rates, which is especially important in a rising rate environment.

CONTRIBUTORS

David Kilborn, CFA - Chief Investment Officer
Peter Milne - Head of Asset Allocation

ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for more than 25 years.

Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds or separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our investors.

We are 100% employee-owned and currently manage $4.29 billion in captive assets worldwide as of October 31, 2018. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

CONTACT US

Hamilton, Bermuda
25 Church Street, 2nd Floor
Hamilton HM12, Bermuda

Hugh Barit
Chairman & CEO
(441) 295-6754
hbarit@performa.bm

Megan Belvedere
Client Service Associate
(441) 295-6754
mbelvedere@performa.bm

Charleston, South Carolina
960 Morrison Drive, Suite 200
Charleston, SC 29403

David T. Kilborn, CFA
CIO & President
(843) 297-4130
dkilborn@performausa.com

Warren Miller
US Client Relationship Manager
(843) 952-7204
wmiller@performausa.com

Burlington, Vermont
60 Lake Street, Suite 1D
Burlington, VT 05401

Sandi Prescott
Head of Client Service
(802) 540-1791
sprescott@performausa.com

John James
Head of US Business Development
(802) 540-1752
jjames@performausa.com