



Investment Perspective

Invesco Fixed Income



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High Yield Bonds

The equity alternative?

Equity securities are once again providing anemic returns for investors. The S&P 500 Index year-to-date total return at the end of the third quarter was 3.89%.¹ For the same time period, high yield bonds, as measured by the Barclay's High Yield Bond Index, had a total return of 11.53%.²

Comparisons to Equities and Risk in High Yield

High yield bonds and equities were strongly correlated from the start of the year through mid-June as correlations across the capital markets were high amid what some have called the "risk-on, risk-off" market. Equities made new lows for the year in early July, high yield held at levels well above its lows and soon started advancing. This is a good example of high yield's lower sensitivity to current concerns about economic growth that have knocked down equity returns. It's also a testament to the power of high yield's dividends in driving returns; they accumulate even in a sideways market. Looking even further back at historical numbers, high yield bonds have outperformed equities over the past 25 years. The S&P 500 annualized returned 7.61%¹ while the Barclay's High Yield Bond Index annualized returned 9.10%.²

While the recession is officially over, growth is expected to remain low for the next several years as imbalances in the economy are gradually corrected. This may not be a great scenario for the stock market, but for high yield investors this could be a goldilocks scenario. In essence, positive growth, but growth not powerful enough to produce inflation and higher interest rates, extends the reach for yields. Growth just strong enough to create the cash flows needed to service debts keeps creditors happy, but might not please the equity owners.

So where are the risks in high yield bonds? The risk of default remains plausible for some companies, but the picture has been steadily improving for most issuers since 2009. Defaults that occurred in the recession helped clean out the weaker companies leaving behind a stronger asset class. Par-weighted default rates for high yield bonds decreased for the 11th consecutive month as of Sept. 30, 2010 to 2.54% over the last 12 months. That is the lowest default level for high yield bonds since December 2008.³ September marks the 15th consecutive month in which loan defaults have

Data as of Sept. 30, 2010, unless otherwise stated.

1 Source: Bloomberg L.P., 9/30/10.

2 Source: Barclays, 9/30/10.

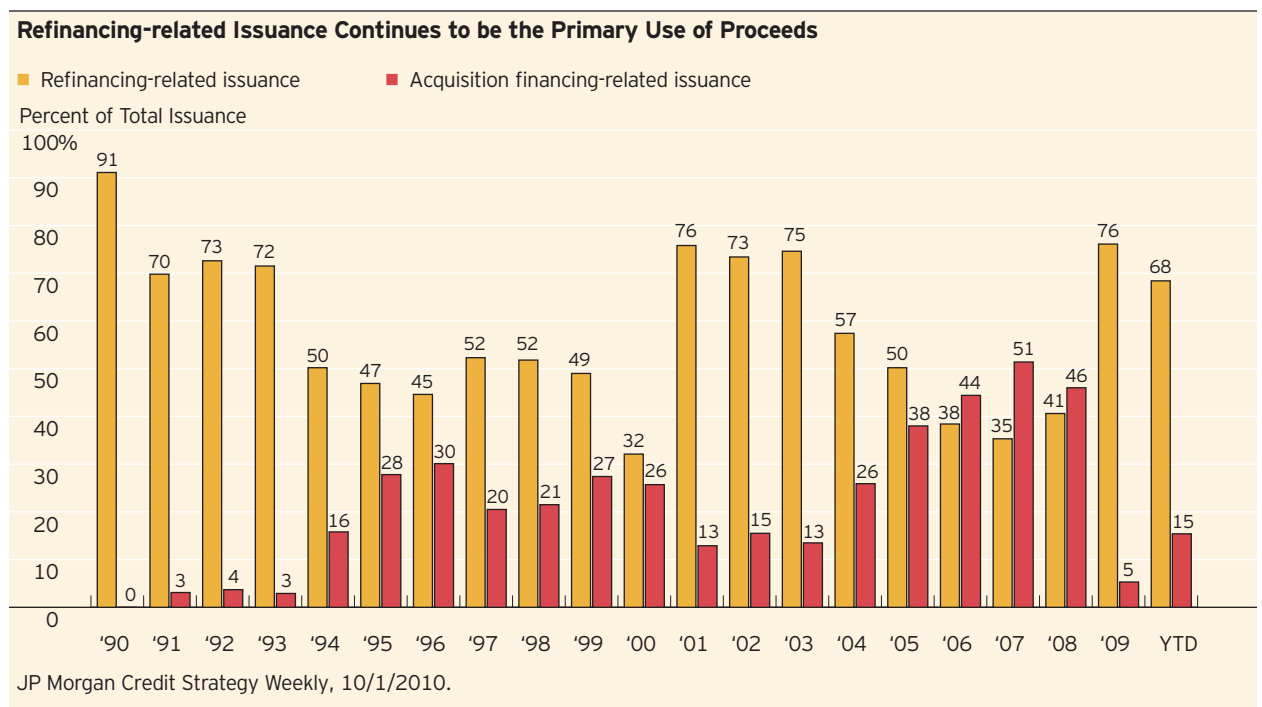
3 Source: JP Morgan Default Monitor, 10/1/10.

outpaced bond defaults. Excluding defaults in which the defaulting company had both bonds and loans, more than four times as many defaults affected loan borrowers than bond issuers over the last 12 months.¹ This evidence suggests that high yield bonds went into the recession in better shape than leveraged loans, where most of the default activity has been taking place. JP Morgan's default forecast for 2011 continues the trend of declining default rates with a forecast of 1.5% for high yield bonds.²

Coming out of this recession, default recoveries for senior secured bonds have averaged 56%. First-lien loans averaged 70.8%. Overall, not bad but when you look at senior unsecured and senior subordinated bonds with recoveries of 29.8% and 34.3%, respectively – the story is not as good. Furthermore, for second-lien loans the recoveries were 13.3%.² Bottom-line, where you were in the capitalization structure going into the recession has had a big impact on recovery values coming out and mitigating losses.

“Good enough” growth is good to keep a lid on high yield defaults and mitigating losses. A renewed recession would be a clear negative for high yield, but the slow-to-moderate growth that we expect is generally good enough to avoid credit problems in most high yield companies. Slow growth may also support credit in a way that isn't typically realized. Cautious outlooks tend to feed through to company behavior in a creditor friendly way. Cautious companies tend to do things such as build cash reserves, pay down debt, forego dividends, and avoid potentially risky acquisitions and expansion plans. Caution favors creditors like high yield note holders.

The supply of high yield bonds has been plentiful this year. High yield bond issuance of \$210.7 billion as of Sept. 30, 2010, has surpassed overall issuance for 2009 of \$181 billion.³ Refinancing has made up the bulk of the issuance this year versus 2006 and 2007 when new issuance was often used as a way to enhance leverage. It's evidence of companies' lower risk-taking. Senior secured bond deals have made up a large portion of the new issuance, more than doubling that in any year prior to last year. The volume of new issuance has lessened the need for forced refinancing and potential default by pushing out the overall maturity structure of the asset class.



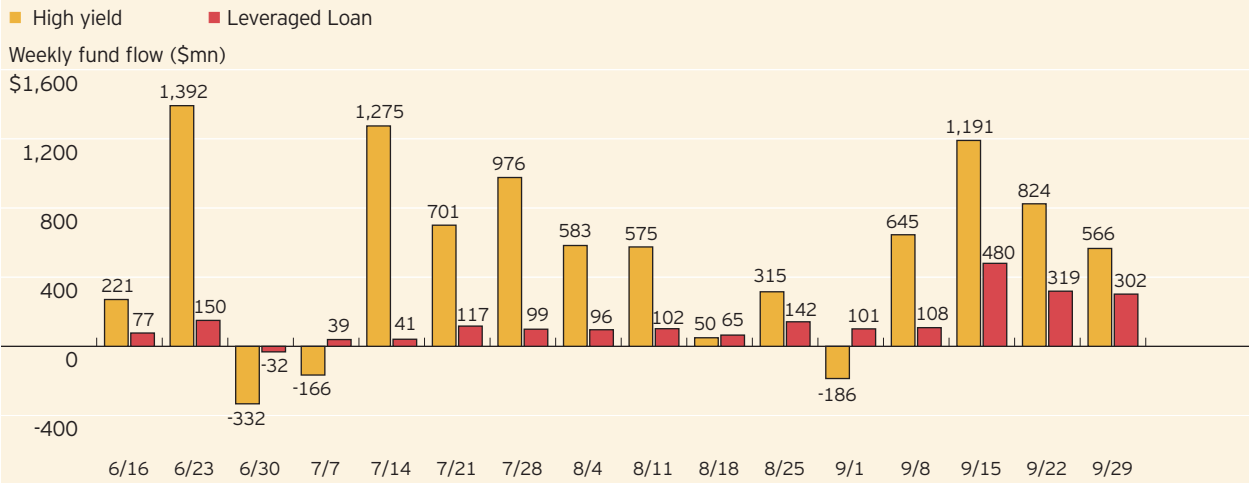
Demand has remained brisk as investors reach for yield in a low yield environment. Investors are responding to both a lower risk environment and the problem of earning near zero returns in risk free assets. Year-to-date inflows into high yield bond mutual funds rose to \$8.1 billion as of Sept. 30, 2010.³ Flows have moved hand-in-hand with economic uncertainty this year, peaking when markets calm and retrenching during economic angst, such as the Greece crisis. However, the overall result has been strong positive flows which we anticipate will continue as alternative yields are expected to remain low for some time.

1 Source: JP Morgan Default Monitor, 9/1/10.

2 Source: JP Morgan Default Monitor, 10/1/10.

3 Source: JP Morgan Credit Strategy Weekly Update, 10/1/10

High-Yield Bond and Bank Loan Funds Reported Another Large Inflow



Source: JP Morgan Credit Strategy Weekly Update, 10/1/10.

Spread levels of 525-615 basis points, depending on the index used, remain above historical averages and most forecasts are for an additional 25 basis points of tightening before year end. This would result in total returns for high yield this year of 13-14%.

Spread to Worst



Source: JP Morgan Credit Strategy Weekly Update, 10/1/10.

Conclusion

There is no doubt that when the economy is strong, stocks provide greater upside than high yield bonds, but when growth slows or recessions hit, the downside risk to stocks is potentially greater than that of high yield bonds. It would have been possible for a stock portfolio to beat high yield bonds over the past twenty-five years, but to do so would have required great market timing. For those investors who don't possess those skills or do not desire to take on market timing risks, high yield bonds provide a great complement to other asset classes.

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