Quiet Counsel

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Investment Outlook

Leith Wheeler
INVESTMENT COUNSEL LTD.

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and theirs.

High Yield Bonds in a Diversified Portfolio

Overview

Bond investments are a key component of most investment portfolios, providing a fixed income stream from coupon payments and often providing stability during periods of market stress.

High Yield Bonds – essentially corporate Bonds that are rated below BBB- or Baa3 – can also form a key component of balanced portfolios. As the name implies, High Yield Bonds offer higher yield and the potential for higher total returns than Investment Grade Bonds. High Yield Bonds have also produced solid risk-adjusted returns relative to other major asset classes, including Equities, with significantly better downside protection. As a result we believe that High Yield Bonds warrant consideration as part of a diversified investment portfolio.

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What Are High Yield Bonds?

High Yield Bonds are Corporate bonds with lower credit ratings (below BBB-), which generally have higher coupon payments than Government or Investment Grade Corporate Bonds. High Yield Bonds receive a lower credit rating from independent rating agencies because they are seen to have a higher likelihood of default than Investment Grade Bonds for a variety of reasons. However, these independent rating agencies have not always been correct in their assessment of whether an issuer will repay their debt or not.

The global High Yield Bond market has grown significantly in terms of issuance, outstanding securities and investor interest over time. Issuance can vary from year to year depending

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on economic and market conditions, typically expanding along with economic growth and investors' appetite for risk and contracting during recessions or market environments when investors are more cautious. Today, the global High Yield Bond market has an aggregate market value over US$2.2 Trillion, with the U.S. currently representing over 60% of outstanding issuance. To put this into Canadian context, the U.S. High Yield Bond market is larger than the entire Canadian Equity market. By comparison the $10 Billion of Canadian High Yield Bonds, equates to less than 0.5% of the global High Yield Bond market.

Companies that issue High Yield Bonds vary in terms of quality, industry sector and risk and include many household names like Alcoa, Dell Computers, Levi Strauss and Heinz.

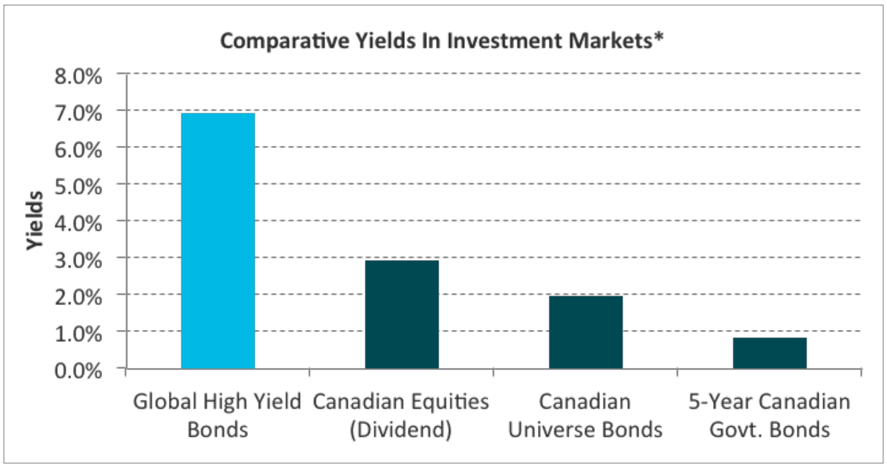
With lower volatility than Equities and less interest rate sensitivity relative to other income producing investments, High Yield Bonds offer a valuable tool to diversify investors' portfolios.

Benefits of High Yield Bonds in a Diversified Portfolio

1. Enhanced Income

High Yield Bonds typically provide better income than Investment Grade and Government Bonds. To illustrate, as at June 30, 2015, the broad U.S. High Yield Bond market offered a yield of 6.73%, compared to just 2.46% for Canadian Investment Grade Corporate Bonds[1].

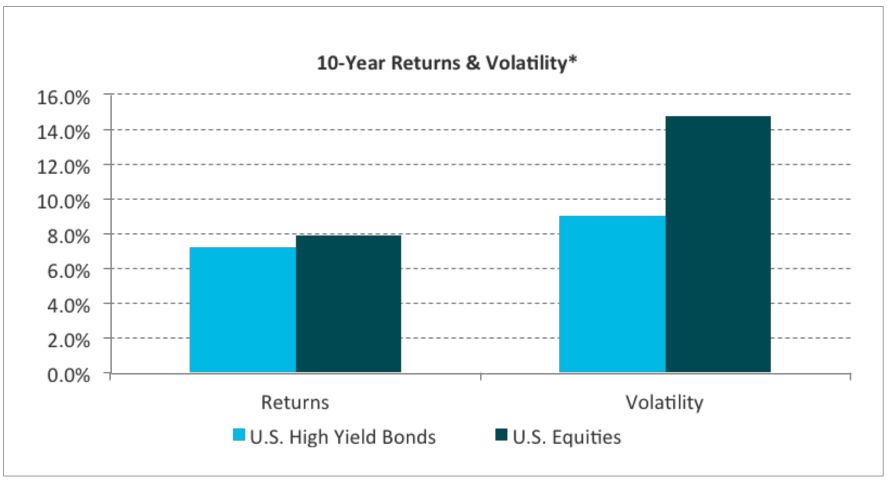
The following table compares the current yields offered by global High Yield Bonds to other publicly traded, income producing investment options.



***Sources:** Bank of America Merrill Lynch Global High Yield Constrained Index (Global High Yield Bonds), S&P/TSX Composite Index (Canadian Equity Dividend Yield), and FTSE TMX Canada Universe Bond Index (Canadian Universe Bonds). Data as of June 30th, 2015.

2. Capital Appreciation

High Yield Bonds tend to have greater potential for capital appreciation during periods of improving corporate performance, take-over activity or even broader improvement in the global economy than Investment Grade or Government Bonds. As a result, the High Yield Bond market has historically had similar long-term historical returns to Equities. However, High Yield bonds have shown significantly lower volatility, as illustrated by the chart on the right.

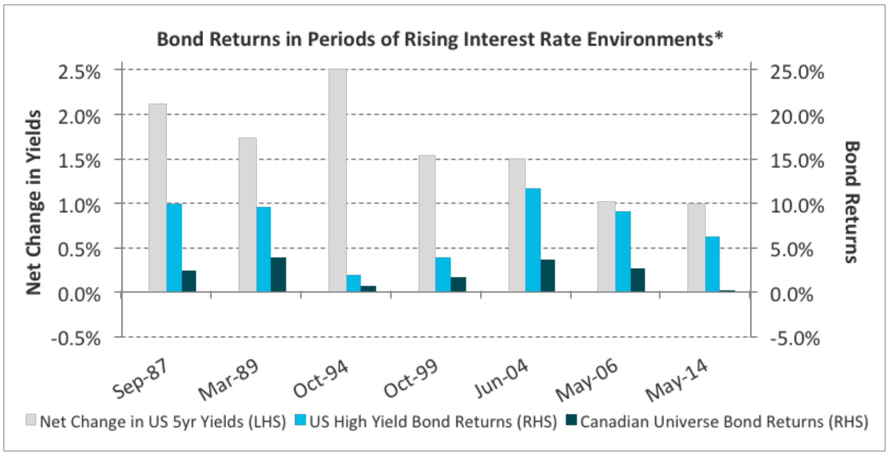


***Sources:** Bank of America Merrill Lynch US High Yield BB-B Constrained Index (US High Yield Bonds), S&P 500 Index (US Equities). Total returns and volatility are calculated on an annualized basis for the 10-year period ending June 30th, 2015.

[1] **Source: Bloomberg, Bank of America Merrill Lynch US High Yield Constrained Index, FTSE TMX Canada Debt Market Indices**

3. Lower Duration/Interest Rate Sensitivity

High Yield Bonds generally have shorter average durations (lower interest rate sensitivity) than Investment Grade Bonds. High Yield bonds are typically issued with maturities of seven years or less and often include call features that reduce their effective maturity to just four to five years. This translates to an average duration of approximately four and a half years on High Yield Bonds, compared with over seven years for the Canadian Investment Grade Bond Index. As a result, High Yield Bond portfolios tend to be significantly less sensitive to interest rate movements than typical Investment Grade Bond portfolios, making them a complementary addition to most balanced portfolios. Because rising rates negatively impact returns from fixed income investments, lower interest rate sensitivity is particularly important in a rising interest rate environment like we are likely facing today.



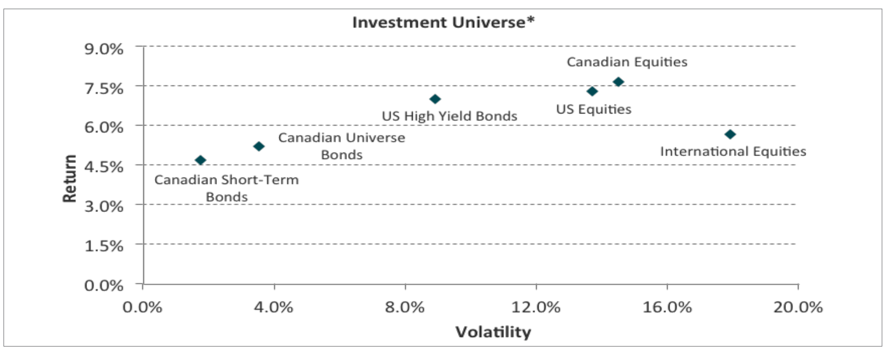
***Sources:** Bank of America Merrill Lynch US High Yield BB-B Constrained Index (US High Yield Bonds), FTSE TMX Canada Universe Bond Index (Canadian Universe Bonds). Net changes in US five-year yields and total returns are calculated for the 12-month period ending on the specified month.

Why Not Just Invest in Equities?

High Yield Bond portfolios typically exhibit positive correlation to Equity portfolios.

However, due to the higher income component of High Yield Bonds, they tend to exhibit less total return volatility than Equities. This is due to the fact that the coupon payments on High Yield Bonds essentially help offset some of the market declines. Secondly, as a portfolio diversifier, High Yield Bonds differ from typical Dividend Equity Funds, as a result of their low weighting in financial service companies. Another stabilizing feature of High Yield Bonds is that their coupon payments are a legal obligation of the issuing company, whereas the dividends paid by Equities can be adjusted or cancelled at the issuer's discretion.

The following chart illustrates the favourable risk-adjusted returns High Yield Bonds have delivered relative to other publically available investments.



***Sources:** Bank of America Merrill Lynch US High Yield BB-B Constrained Index (US High Yield Bonds), FTSE TMX Canada Universe Bond Index (Canadian Universe Bonds), S&P 500 Index (US Equities), S&P/TSX Composite Index (Canadian Equities), MSCI EAFE Index (International Equities), and FTSE TMX Canada Short Term All Corporate Bond Index (Canadian Short-Term Bonds). Total returns and volatility are calculated on an annualized basis for the 10-year period ending June 30th, 2015

What About Defaults?

In the event of default and bankruptcy, High Yield Bond investors receive a higher priority in their claim on company assets than Equity investors, but typically have less security than Investment Grade Bonds.

While a lower credit rating should indicate a higher likelihood of default for High Yield Bonds, over the long term, defaults have accounted for a relatively small percentage (approximately 4%) of all outstanding High Yield Bonds. In the case of default, High Yield Bond investors have on average recovered 40% of their principal, compared to little or no recovery by Equity investors. This preferential downside protection is due to the priority position of High Yield Bonds in a company's capital structure relative to Equities. In today's market environment, defaults are low (1-2%) relative to historical averages.

High Yield at Leith Wheeler

Leith Wheeler has a long history of identifying value opportunities in the Equities of high quality, publically traded companies, which has allowed us to deliver attractive returns to our clients over the long-term.

Our work in the High Yield Bond market is a natural extension of our established, value-based investment philosophy. After thorough consideration, we launched the Leith Wheeler High Yield Bond Fund in June of this year. The Fund invests in global High Yield Bonds, with a bias towards the much larger and more liquid U.S. High Yield Bond market.

Agency credit ratings provide a framework for evaluating the High Yield Bond market, and many firms in the investment industry rely on these ratings when building client portfolios. However, at Leith Wheeler we conduct in-depth, independent credit analysis on every security we consider for inclusion in client portfolios to form our own conclusions about its credit quality and potential return.

Similar to the Equity portfolios we manage for clients, the High Yield Bond fund will hold a relatively concentrated set of investments, comprising of our carefully researched, highest conviction ideas. The Fund is benchmarked against the Merrill Lynch BB/B index, and has investment restrictions on our ownership of CCC or lower rated Bonds, reflecting our focus on higher quality issuers and the emphasis we place on capital preservation over our clients' long-term investment horizons.

While there is a compelling case that the addition of High Yield Bonds improves a balanced portfolio's return potential and risk profile, the source of funds to facilitate their inclusion is highly dependent on the specific factors that shape your unique investment objectives. Our experience suggests that a range of between 3% and 15% of the overall portfolio represents an appropriate allocation to High Yield Bonds for most investors, with their addition funded by the sale of existing Bond or Equity holdings, or a combination thereof. When considering the appropriate allocation to High Yield Bonds in your portfolio we suggest speaking with your Leith Wheeler Investment Advisor to determine how they can complement your existing portfolio and help you achieve your long term investment goals.

Authors: Dhruv Mallick, CFA, Fixed Income Analyst and Ben Homsy, Institutional Portfolio Management, Fixed Income

Editor: Michael Job, CFA, Portfolio Manager

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Vancouver Office
Suite 1500 400 Burrard Street
Vancouver, British Columbia V6C 3A6
Tel: 604.683.3391 Fax: 604.683.0323

Calgary Office
Suite 570 1100 1st Street SE
Calgary, Alberta T2G 1B1
Tel: 403.648.4846 Fax: 403.648.4862