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Investing in high yield bonds

Contents

Introducing high yield bonds

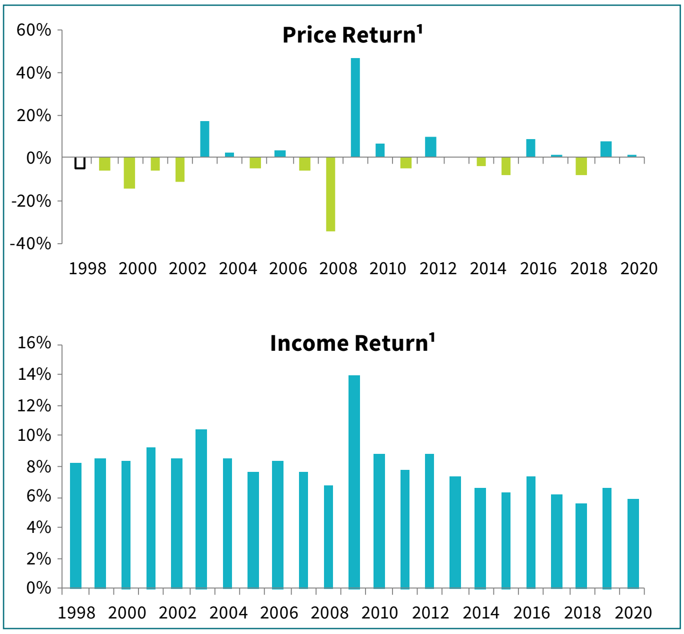
The growth of the global economy has created many new investment opportunities over the past several decades, with wealth increasingly spread across the world. As a result, we have seen the growth and maturation of many new asset classes, with high yield bonds one notable example.

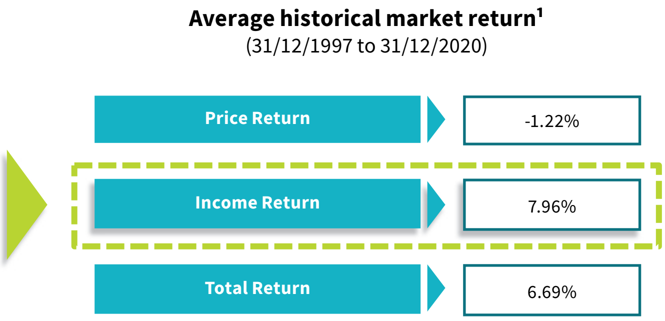
High yield bonds are issued by companies with a relatively low credit rating, which may not have been able to access capital markets in the past. The asset class offers investors a higher risk, higher return opportunity than more traditional fixed income markets, one which may prove attractive in a world where returns can be hard to come by. High yield performance is largely driven by coupon payments, with the global market delivering a total return of 6.69% over the past two decades or so.

We believe that the key to achieving attractive returns within high yield is to compound income and avoid capital loss. Investors who do so can make the most of what the asset class can offer, while seeking to avoid its principal risk – that of companies defaulting on their debt.

High yield bonds can form an attractive part of a wider portfolio. Chart 2 shows the annualised return and volatility for a range of different asset classes over the 20 years to the end of March 2021. As you can see, global high yield bonds have delivered a higher annualised return with lower overall volatility than US equities. This will not always be the case, but it demonstrates the robustness of the global high yield market.

Chart 1: Global high yield returns since 1998.[1]

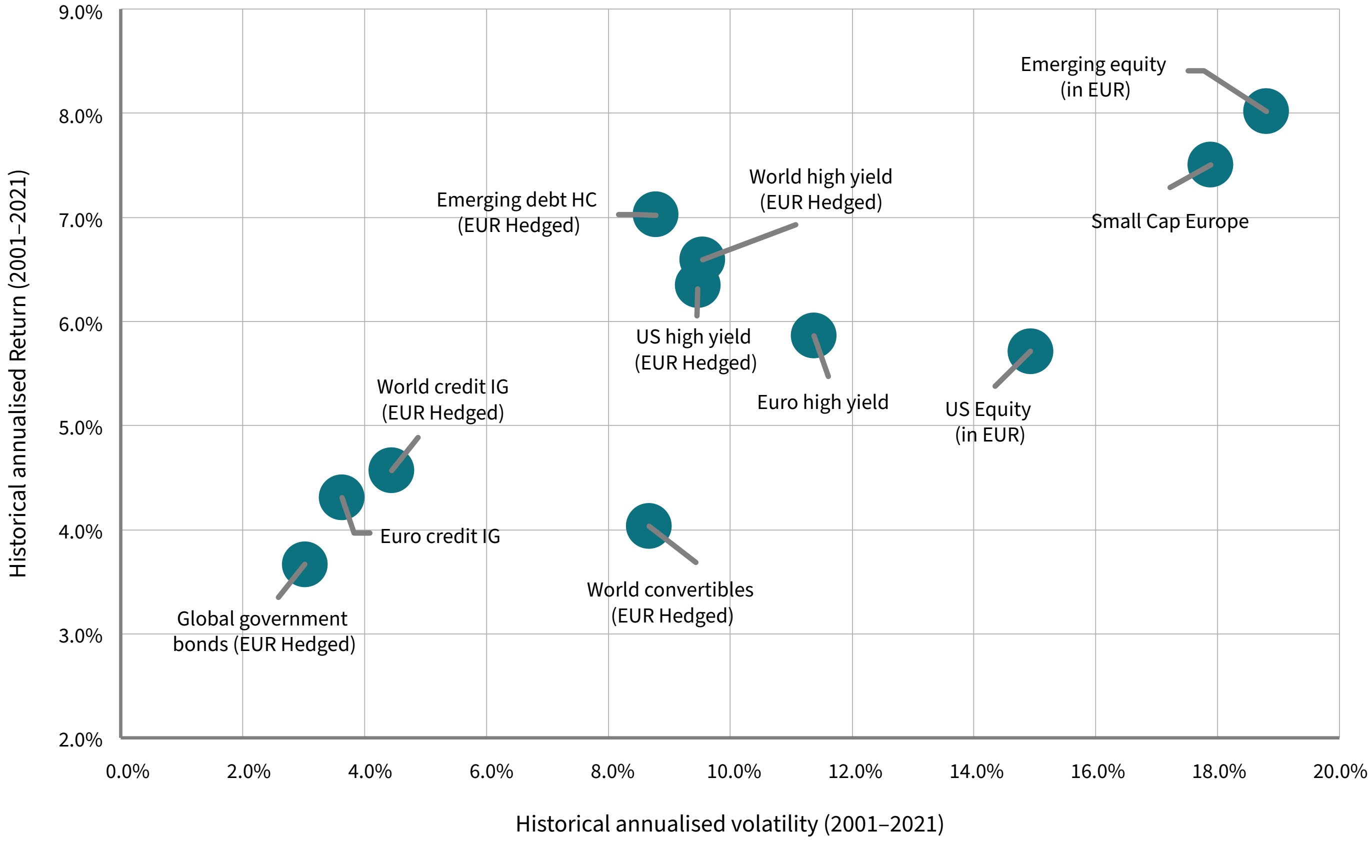




Source: AXA IM / ICE BofAML as at 31/12/2020.

[1] ICE BofAML Global High Yield Index. Past performance is not a guide to future performance. No assurances can be made that profits will be achieved or that substantial losses will not be incurred.

Chart 2: risk/reward profile of high yield bonds vs. other asset classes



Source: AXA IM, Bloomberg, Thomson Reuters Eikon, based on monthly returns. March 2021.

Key advantages of high yield bonds

1. Investors can benefit from high yield’s attractive income stream and compound their returns over time.

2. An allocation to high yield bonds contributes to a well-diversified portfolio. While high yield bonds are a high-risk fixed income asset class, they remain less risky than equities.

3. Investors can benefit from the potential for capital gains in high yield bonds to a greater extent than investment grade bonds. Rating upgrades or positive market developments can lead to high yield bonds performing strongly, especially during the recovery phase of the economic cycle.

What are the risks?

Default risk: The biggest risk involved in the high yield universe is default risk, where companies fail to repay a portion of their debt. High yield issuers tend to have weaker balance sheets than investment grade companies and can be hurt more by a deterioration in economic fundamentals. The key to successful high yield investing is to avoid capital loss.

Over the last twenty years (including the Global Financial Crisis and COVID-19 pandemic), the average default rate for US and European high yield issuers has been 4.49% and 3.51% respectively.[2]

While default rates picked up as a result of the pandemic, they remained relatively low compared to other periods of turbulence, such as the bursting of the dotcom bubble.

Illiquidity: High yield bonds are traded "over the counter" (OTC) rather than on the stock market, and this can sometimes make them hard to buy and sell. This illiquidity can mean prices are more volatile than those of investment grade bonds. As with all bonds, any potential rating downgrade – threatened or otherwise – can have an impact on the price of a bond.

[2] Source: Default data from Moody's as at 31/01/2021. Historical data since December 2001.

What does the global high yield market look like?

The international high yield market has grown significantly over the past twenty years, and was worth approximately $2.6tn by the end of 2020. There were more than 3,700 issuers, with the market having produced an average annual total return of 6.69% between 31/12/97 and 31/12/20.[3]

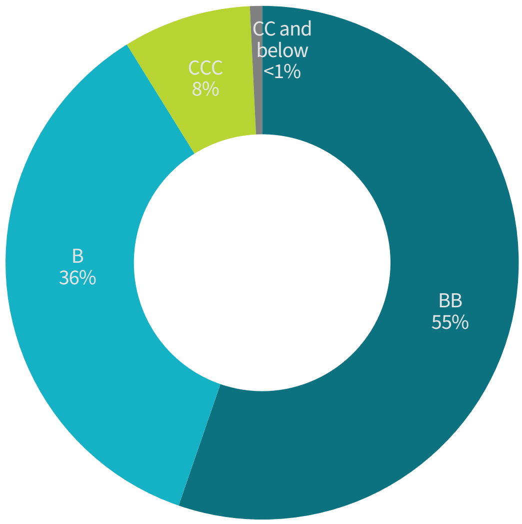
As at the end of February, the average linear rating was BB3 with a full range of industries and sectors represented. Energy, telecoms and basic industry accounted for the top three sectors, with the insurance sector the smallest, accounting for just 1% of the global high yield market.[4]

The high yield market by rating and industry sector*

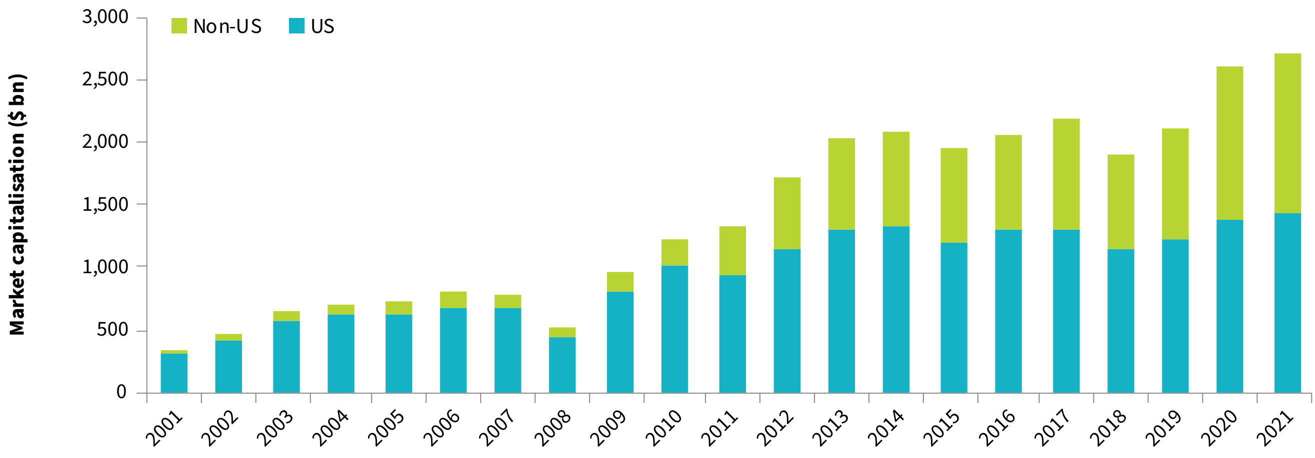
Key characteristics

Market value ($bn)	2717
Modified duration (yrs)	3.69
Yield to worst (%)	4.32
Number of issues	3779
Number of issuers	1589
Average linear rating	BB3

Breakdown by Rating



Breakdown by type*



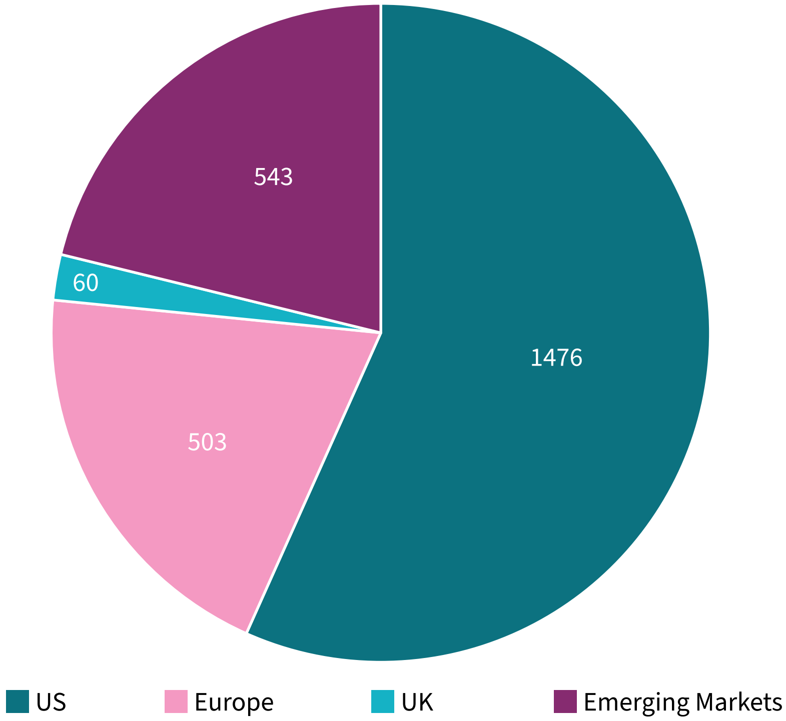
*Source: AXA IM, Bloomberg as at 28/02/2021. Split of global high yield market value in USD million. Yield figures quoted will vary in the future and are not guaranteed. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

3 AXA IM / ICE BofAML as at 28/02/2021. Performance numbers as of 31/12/2020. Market represented by ICE BofAML Global High Yield Index. Past performance is not a guide to future performance. No assurances can be made that profits will be achieved or that substantial losses will not be incurred.

4 Source: AXA IM / Bloomberg as at 31/03/2021. (HW00: ICE BofAML Global High Yield Index). *Split of market value in USD million. Yield figures quoted will vary in the future and are not guaranteed. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

The US high yield bond sector is the largest and most developed globally. However, other regions have seen significant growth in their high yield markets over the past two decades, offering investors significant choice and geographic flexibility.

Chart 3: International high yield market by region[5]



Source: ICE BofAML as at 31/03/2021.

This development allows investors to access a diverse range of high yield opportunities today, with markets able to be blended to suit an investor's ultimate objective. In general, for example, European high yield issuers have higher credit ratings, with the region's bonds also tending to be shorter in duration, potentially appealing to investors concerned about rising interest rates.

Comparing US and European high yield[6]

	US high yield	European high yield
Size of market (USD bn)	1,470	516
Number of issuers	2,050	719
Average rating	B1	BB3
Duration (modified to worst)	3.64	3.57
Yield (to worst)	4.36%	2.75%

[5] Source: ICE BofAML as at 28/02/2021.

[6] Source: ICE BofAML as at 28/02/2021. Performance is shown hedged in USD. Past performance is not a guide to future performance. The ratings shown are the linear average of the ratings for Moody's, S&P and Fitch rounded to the nearest integer.

Investing in high yield bonds with AXA IM

We believe that a focus on compounding current income and avoiding defaults is critical to achieving good returns in the high yield market. Our deep-rooted expertise helps us to achieve these criteria, with our team of 19 high yield bonds specialists having an average of 16 years' industry experience[7] Worldwide, we now manage more than €17bn in high yield mandates, part of our wider €541bn in fixed income assets under management.[8]

We have been managing high yield bond strategies since 2002, giving us experience across a range of market cycles and different environments, including the Global Financial Crisis, Eurozone Crisis, and COVID-19 pandemic. Throughout this time, our repeatable and disciplined investment process has helped us to deliver for our clients. Our Global High Yield strategy has seen just 19 defaults from 2002 to the end of 2020, for example, compared to more than 1,064 for the index.[9]

A thorough investment process

We split our investment process into three stages, looking at bottom-up and top-down factors across the whole of the process. A robust and repeatable approach to investing can help to deliver consistent investment performance for our clients. Please note, however, that the factors mentioned below are not the only areas we look at when investing.

1. Fundamental analysis

To begin with, we assess the risk of an individual issuer through fundamental credit analysis. This involves assessing their historical performance and projected financials, amongst other areas. We also consider the macro context and industry picture of the issuer as well as any secular or structural investment themes.

2. Relative value analysis

At the second stage, we seek to identify relative and absolute return opportunities. This allows us to compare risk and returns across the whole of the market and identify areas which may be attractive. We consider various criteria, including internal and external credit assessments, industry classification and the capital structure of the issuer.

3. Portfolio positioning

Finally, we seek to bring this all together in portfolio positioning. Portfolios are constructed to benefit from individual credit assessments with top-down risk management, targeting credit, duration, curve and liquidity risk, amongst others.

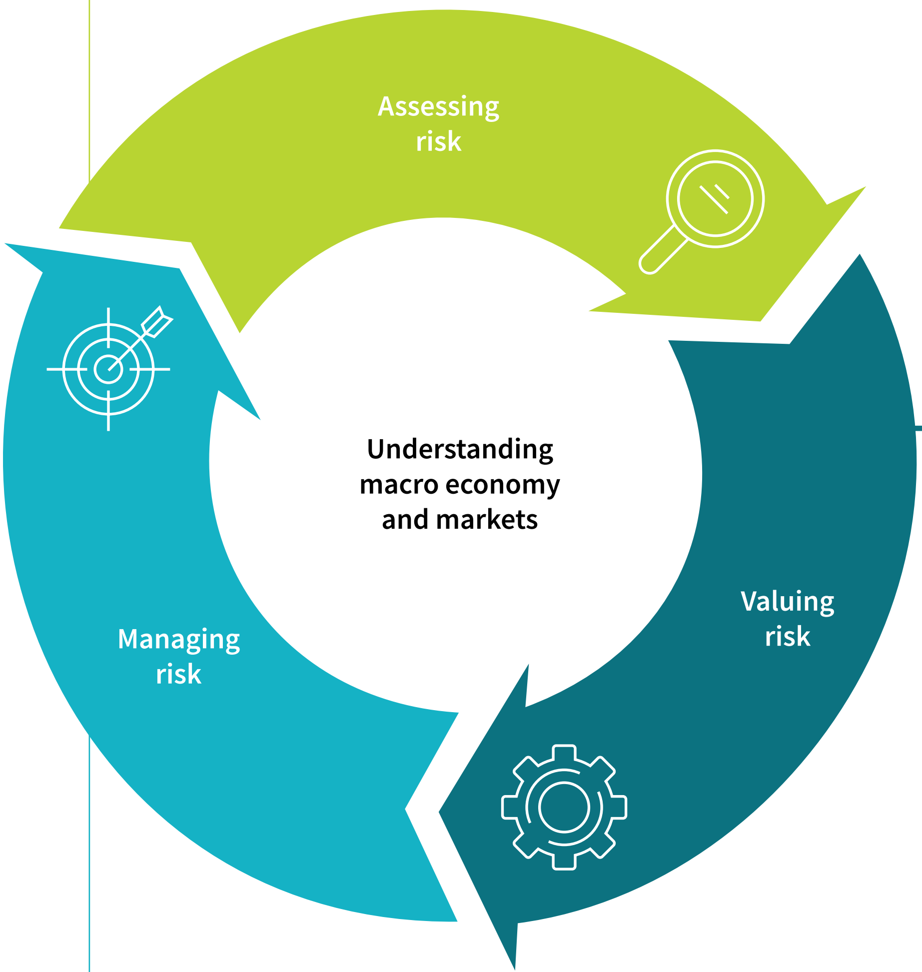
7 AXA IM, as at 31/05/2021.
8 AXA IM, as at 31/03/2021.
9 AXA IM, as at 31/12/2020. Benchmark is the BAML Global High Yield Index. Past performance is no guide to future results.

Our investment process

1 FUNDAMENTAL ANALYSIS

Identify micro and macro risks at the issuer level

- Business due diligence
- Financial analysis
- Liquidity projection
- Capital structure review



2 RELATIVE VALUE ANALYSIS

Evaluate pricing in current market environment

- Internal credit assessment
- External credit ratings
- Industry classification
- Credit curve
- Capital structure
- Custom segmentation

3 PORTFOLIO POSITIONING

Balance idiosyncratic and systematic risk against return opportunity

- Interest rate risk
- Sector risk
- Equity-like risk
- Yield curve risk

The investment process described above is provided for illustrative purposes only, and no assurance can be given that it will be applied at any given time. Please note that the investment process is subject to change without prior notice and cannot be considered as a reliable indicator of the ability of AXA IM to manage and mitigate risks, nor can be relied as a guide to future performance.

Our high yield offering

We offer a wide variety of high yield bonds funds, including global and regional specific investment vehicles as well as shorter duration and low carbon products. The breadth of our offering allows investors to choose the product most suited to their investment needs and objectives and gain access to all the high yield universe offers.

Low carbon

We launched our US High Yield Low Carbon product in February 2021, offering investors a more environmentally conscious portfolio which targets a carbon footprint at least 20% lower than the ICE BofA US High Yield Index. The strategy's carbon footprint is managed through the selection of underlying securities after excluding the most carbon intensive sectors, such as metals, mining and steel producers, and most sub-sectors within the energy and utility sectors.

As a fundamental credit manager, the investments will be largely driven by our credit risk assessment and relative value analysis.

Short duration bonds

Investors may wish to consider our short duration strategies if they are concerned about the potential for higher interest rates. Shorter duration bonds are less sensitive to rising interest rates and investors can have greater confidence about the repayment of shorter duration debt as these bonds are typically redeemed within five years at the upper end and so less subject to long-term uncertainties.

Why invest in short duration bonds with AXA IM?

We developed our first short duration strategy in 2001, and now manage around €6bn in short duration strategies.[10] We have seen very few defaults in our short duration strategies, with only two defaults in the AXA IM FIIS US Short Duration High Yield strategy between inception and the end of February 2021, compared to 643 for the wider index.[11]

Our investment team has a strict sell discipline and pays close attention to worsening company fundamentals or declining bond liquidity. This helps to minimise the number of bonds sold at a significant loss (i.e. greater than 30%).[12]

[10] AXA IM, as at 31/05/2021.

[11] J.P. Morgan Default Monitor as of March 1, 2021, AXA IM US SDHY Representative Portfolio stream (data prior to March 2004 is based on legacy portfolios managed in the same investment strategy).

[12] See AXA IM US Short Duration High Yield strategy, for example. Only 12 bonds were sold at a loss of more than 30% between 2002 and 2020, with a further 18 sold at a loss of between 20–30% over the same time period.

Product overview: high yield

Global High Yield

	Investment objective	Inception date
AXA WF Global High Yield	To achieve a high income by investing in fixed and floating rate securities, with capital growth being a secondary consideration. Typical investors would seek a high income measured in USD.	28/08/2008[13]

US High Yield

	Investment overview	Inception date
AXA WF US Core High Yield	To seek high income and capital growth by investing in US high yield debt	30/09/2001
AXA WF US Short Duration High Yield	To seek high income by investing in US high yield debt with an expected life term or redemption inferior to three years on the basis of the asset manager anticipations.	30/09/2001
AXA WF US Dynamic High Yield	The Sub-Fund investment objective is to seek high income by investing in US high yield debt. The higher risk tolerance and concentrated nature of the portfolio, along with the CDS-derived leverage (up to 150%) are targeted to enhance returns in neutral and bull markets.	28/02/2014
AXA WF US Enhanced High Yield	The Sub-Fund's objective is to seek high income, in USD, mainly through exposure to short duration securities of US domiciled companies. The implementation of leverage (maximum 200%)[14] is a core element of the Sub-Fund's investment strategy.	31/12/2018
AXA WF US Low Carbon High Yield	To seek high income by investing in US high yield debt with a carbon intensity at least 20% lower than that of the ICE BofA US High Yield Index.	29/03/2021

[13] Inception date is since the change of the reference currency to USD of the I USD share class.
[14] Internal constraint.

European High Yield

	Investment overview	Inception date
AXA WF European High Yield	To seek to generate a high level of income by investing in European corporate bonds and bonds issued by European governments.	30/10/2012
AXA WF European Short Duration High Yield	The fund seeks to achieve high attractive income and capital growth by investing primarily in high yield debt securities with an expected duration of three years or less and which are denominated in a European currency over a medium-term period.	05/08/2011

Asian High Yield

	Investment overview	Inception date
AXA WF Asian High Yield Bonds	To seek performance through dynamic exposure to the Asian fixed Income market by investing at least 70% of its net assets in debt securities issued in the Asian debt universe over a medium-term period.	28/11/2016

Key risks from investing in high yield bonds

The risks below refer to the specific risks of investing in the above mentioned high yield funds, as per the KIID documents.

Counterparty Risk: Risk of bankruptcy, insolvency, or payment or delivery failure of any of the Sub-Fund's counterparties, leading to a payment or delivery default.

Market risk: risk of variation of the Net Asset Value during the life of the Sub-Fund due to market movements (assets price volatility, widening of spreads) in general or in specific markets.

Sustainability Risk: Given the Sub-Fund's investment strategy and risk profile, the likely impact of the sustainability risks on the Sub-Fund's returns is expected to be high.

Operational Risk: Risk that operational processes, including those related to the safekeeping of assets, may fail, resulting in losses.

Geopolitical Risk: Investments in securities issued or listed in different countries may imply the application of different standards and regulations. Investments may be affected by movements of foreign exchange rates, changes in laws or restrictions applicable to such investments, changes in exchange control regulations or price volatility.

Liquidity Risk: Risk of low liquidity level in certain market conditions that might lead the Sub-Fund to face difficulties valuing, purchasing or selling all/part of its assets and resulting in potential impact on its net asset value.

Credit Risk: Risk that issuers of debt securities held in the Sub-Fund may default on their obligations or have their credit rating downgraded, resulting in a decrease in the Net Asset Value.

Impact of any techniques such as derivatives: Certain management strategies involve specific risks, such as liquidity risk, credit risk, counterparty risk, legal risk, valuation risk, operational risk and risks related to the underlying assets. The use of such strategies may also involve leverage, which may increase the effect of market movements on the Sub-Fund and may result in significant risk of losses.

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Investment Managers