The Appeal and Challenges of Investing in Asian High-Yield Bonds

The mainstay of fixed income investments, bonds especially high yielding ones carry certain degree of risks but also offer some of the most attractive valuation and returns. *By Ms. Lim Suet Ling*

Asian high-yield bonds are emerging as a new asset class and fast gaining popularity in the high-yield space. Given their relatively recent appeal, high-net-worth (HNW) investors should consider both their unique investment characteristics and the potential challenges in incorporating them into their investment strategy.

But there are some common misconceptions surrounding high-yield bonds and the risks associated with them. So what are high-yield bonds and what type of investor would they appeal to? High-yield bonds represent the debt financing of companies rated below investment grade by the primary rating agencies (Ba or lower for Moody's Investor's Service, BB+ or lower for Standard & Poor's) and carry higher issuer risk.

As a result of the increased probability for default, they have traditionally offered yields above those offered by investment-grade bonds. In addition, they offer the chance for significant price appreciation should the issue or issuer be upgraded by the credit-rating agencies.

Due to their lower credit ratings, high-yield bonds are typically favoured by institutional investors such as asset management companies, hedge fund managers and insurance companies but we are seeing their increasing popularity among individual investors.

They may be suitable for HNW investors with high-risk tolerance and short-to-medium term investment objectives, and are looking for portfolio diversification and higher rates of return relative to investment-grade bonds (see Table 1 on the different rating scales between high-yield and investment grade bonds).

Attractive Valuations

High-yield bonds are typically issued by corporates to meet their capital financing needs. They were a popular means of financing for companies in the United States (US) during the 1980s and 1990s but have since gained wider appeal with issuers from other countries.

Companies that issue high-yield

bonds include start-up companies that require capital funding, on-investment grade companies seeking liquidity in the high-yield market to improve their balance sheets over time; and capital intensive companies in the telecommunications, real estate and transportation sectors that turn to the high-yield market when they are not able to finance all their capital needs through earnings or bank borrowings.

High-yield bonds are commonly perceived to have a higher risk of default relative to investment grade bonds. However, historical data has shown that the default rate is still relatively low even for certain emerging markets, as illustrated in Table 2. Asian high-yield bonds with relatively stable fundamentals have a lower rate of default compared with high-yield bonds in other markets.

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Asian high-yield bonds have attractive valuations. At current valuations, Asian high-yield bonds continue to offer attractive yields. The current yield of more than seven per cent has held steady since the US Federal Reserve's quantitative easing tapering programme which began in May 2013. Meanwhile, the yields on 10-year US treasuries continue to hover below 2% (Bloomberg, J.P. Morgan Asia Credit Index (JACI), 31 October 2015).

Table 1: Credit Ratings of Bonds by International Ratings Agencies

	Moody's	Standard & Poor's	Fitch
Investment Grade	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A	A
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
	Moody's	Standard & Poor's	Fitch
Non-Investment Grade (High-Yield)	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB-	BB-
	B1	B+	B+
	B2	B	B
	B3	B	B
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	C	C	C
	/	D	D

Source: UOB Asset Management Malaysia Bhd

The growing volume of Asian high-yield issues is also providing ample liquidity, adding to its appeal as an asset class. The size of the Asian high-yield bond market prior to 2009 amounted to just US$9 billion. Since then, it has grown 11 times to reach US$100 billion as at end-December 2014. The asset class is expected to grow rapidly and will likely reach US$500 billion by 2020.

China's property sector continues to be the largest, deepest and most liquid within the Asian high-yield market. This is despite the weak market sentiment in the first quarter of 2015 arising from the high concentration of Chinese property issuers and corporate governance concerns. But investors have since regained confidence and returned to the sector encouraged by the attractive valuations and the government's supportive policies to spur the economy.

Even as Chinese developers continue to dominate the space, new issuers have emerged this year from India's banking, transportation and industrial sectors, as well as from Indonesia's telecommunication companies.

Asian high-yield bonds typically display characteristics of equity income markets, sometimes with less volatility. The JACI, the benchmark for Asian high-yield bonds, recorded negative returns in just one calendar year between 2006 and 2014. Meanwhile, equity-based Morgan Stanley Capital International (MSCI) Asia ex-Japan index registered two years of negative returns in the same period.

Also, the JACI generated a 51.4 per cent return over a five-year period from 30 April 2010 to 1 May 2015, similar to

Table 2: Year-to-date Default Rates of Bonds

Default Rate	2010	2011	2012	2013	2014	2015YTD	2015F	HY Bond Stock (US$bn)**
Asia	1.50%	0.00%	2.20%	1.00%	1.40%	1.60%	3.30%	159
Emerging Europe	1.60%	0.60%	4.50%	1.70%	3.50%	0.70%	10.90%	107
Latin America	1.70%	0.80%	2.50%	7.50%	4.90%	1.80%	3.90%	161
Middle East & Africa	1.10%	0.00%	0.10%	0.00%	4.10%	2.30%	5.10%	38
Total EM	1.60%	0.50%	2.70%	3.30%	3.30%	1.50%	5.40%	465

Source: J.P. Morgan as of May 2015
***Bond stock as of December 31, 2014*

the MSCI Asia ex-Japan Index.

Overall, Asian high-yield bonds provide returns similar to equities but with lower volatility.

Interest Rates and Impact On Asian High-yield Bonds

As we are expecting US interest rates to normalise over a longer term, a portfolio with investments in Asian high-yield bonds, with their wider credit spread, will offer greater protection against the negative impact of interest rate rises.

US interest rates are at historically low-levels and it is just a matter of time before they increase, but the pace at which this happens will have an impact on Asian investments. If interest rates rise too fast, we may see capital outflows in Asia's emerging market assets. However, interest rates increasing at a measured pace could restore investors' sentiment and bring technical and fundamental valuations more in line with each other.

Rising interest rates will also lead to a stronger US dollar and investors may become concerned about the economic strength of emerging markets and corporates' foreign-denominated debt. As a result, default risk may rise depending on the profitability and funding mix of these corporates. As such, the market has priced in higher returns for the risks associated with Asian high-yield bonds. Rising interest rates is not the only consideration for high-yield bond investors. Diversification is also important when investing in this asset class.

Most local HNW investors favour funds which are largely invested in bonds issued by Malaysian corporates, although there is some take-up for sovereign and quasi-sovereign bonds. Given this bias, we observe that there is little diversification in their bond investments and little opportunity to seek higher returns.

Malaysian equity investors tend to spread their investments across Malaysian, Asia Pacific and global equities and rarely put all their eggs in one basket. While Asian high-yield bonds could potentially provide good and stable returns, Malaysian HNW investors should apply a similar approach and diversify their fixed income portfolios. SI

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[1]*Source: Bloomberg, 31 March 2015*