Building Portfolio Yield with Resiliency: Top 3 Reasons to Incorporate High Yield Now

Summary

- Today's challenging market environment of heighted market volatility, a hawkish Federal Reserve, along with prevailing inflation rates, poses a pricing risk to investor portfolios.
- High yield ("HY") bonds work as an inflation hedge with attractive returns, having high probability of outperforming other asset classes[1] over the next three-to-five years.
- Income oriented investors will find that the HY bond index has become higher in quality compared to previous market downturns, with lower default rates across wider credit spreads.
- The HY asset class offers investors strategic, income-oriented portfolio diversification with lower correlations to other asset classes.

Income Seeking Investors Should Consider Increasing HY Allocations for the Following 3 Reasons:

I. HY Offers an Inflation Hedge, with High Probability of Outperforming Other Asset Classes

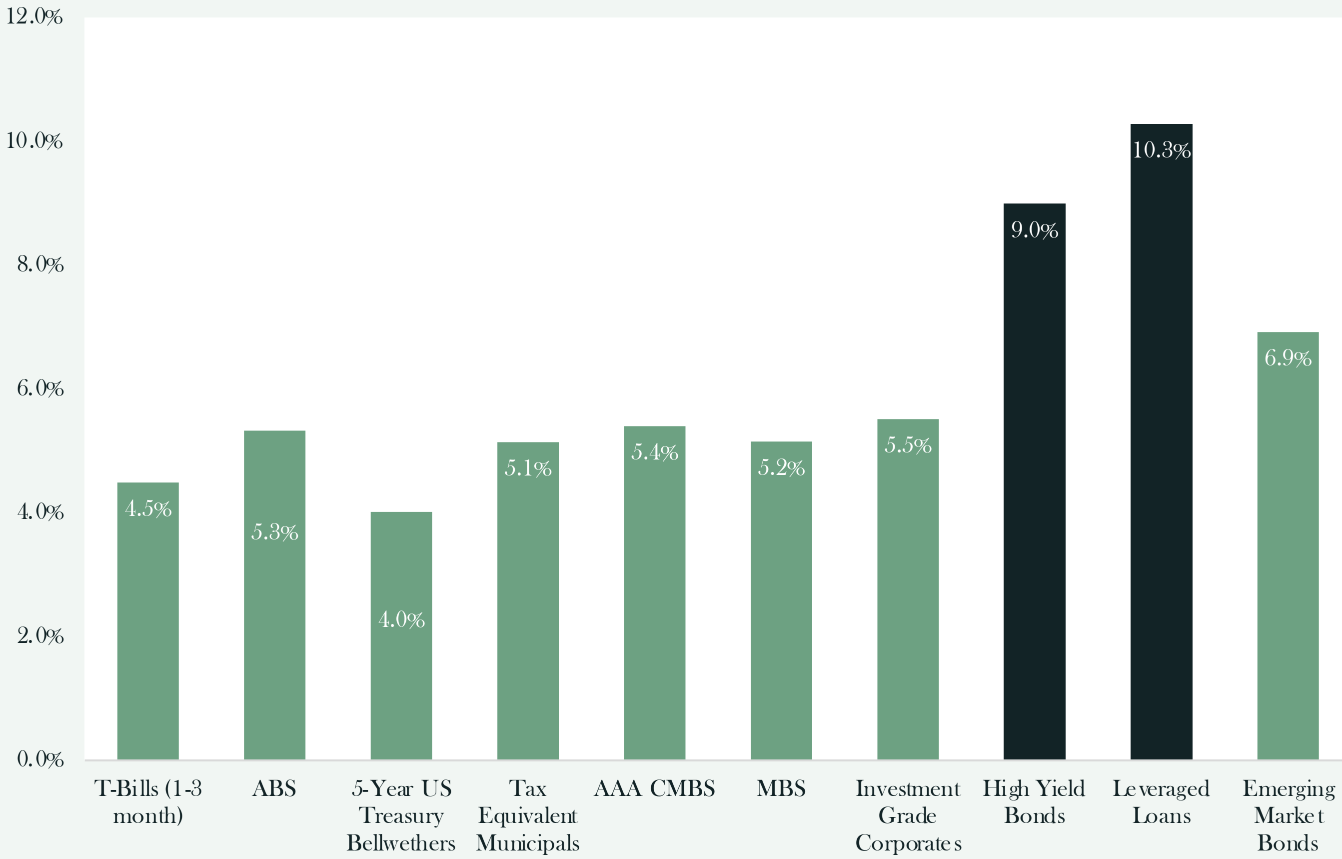
We believe HY has a high probability of outperforming other asset classes in the near to intermediate term. A prominent investment consulting firm is expecting high yield bonds to outperform most traditional asset classes over the next three-to-five years and roughly equivalent to most equity strategies for over 10 years.[1] Meanwhile, HY is currently yielding 9.0% to maturity. Even assuming default rates of 5% each year over the next five years – a very draconian prediction – the expected return for HY is 7%.[2] As compared to other asset classes, (Figure 1), high yield bonds offer more lucrative returns versus other classes along with shorter durations. Because high yield bonds tend to be less impacted by higher interest rates, they prove to be an excellent inflation hedge, offering higher income and spread to cushion increased market rates.

[1]Mercer LLC. (2022). *US CMO Summary Report.*
[2] Source: Barrow Hanley as of 9/30/22

Figure 1

LEVERAGED LOANS AND HIGH YIELD BONDS OFFER HIGHER YIELDS

Fixed Income Yields as of 12/31/22

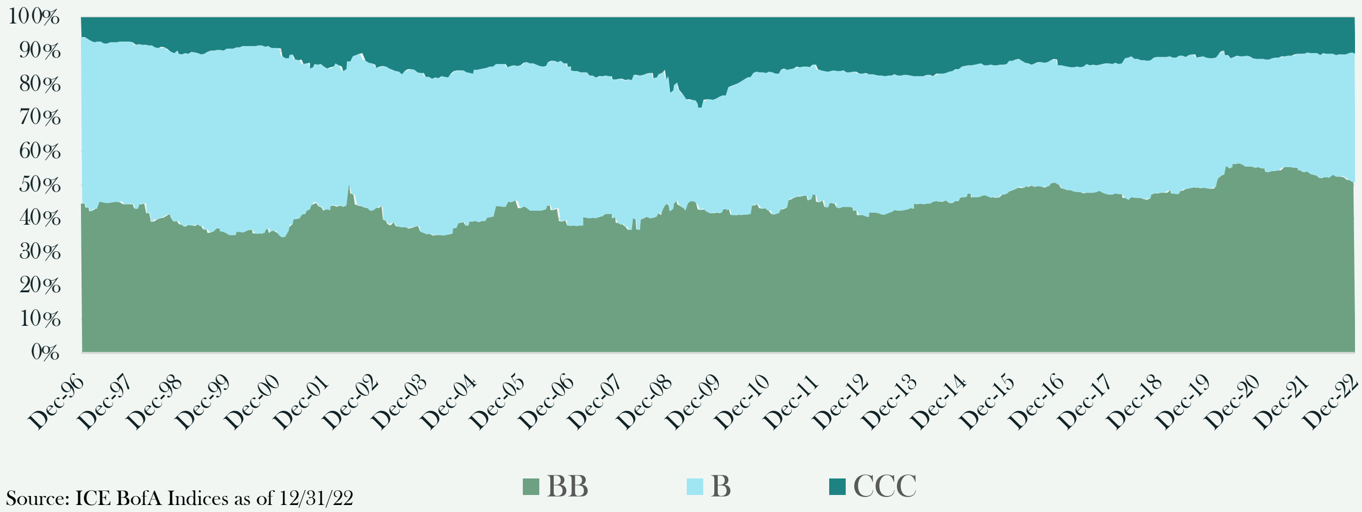


Sources: Bloomberg, ICE BofA, Credit Suisse.

II. Improved HY Market Quality May Reduce Default Risk Compared to Historical while Delivering High Spreads

Bond issuers within the ICE BofA US High Yield BB-B Index ("HY Index") are much higher in quality than they were in the past. In fact, 52% of the High Yield Index is now rated BB. At the onset of the Global Financial Crisis ("GFC"), BBs represented 34% of the Index. The CCC segment of the market accounts for 11% of the Index, down from 15% prior to the GFC (Figure 2). As a result, improved fundamentals help investors earn greater returns at the backdrop of less default risk. Further, the Index's quality shift has made it difficult to discern that current spread levels are quite wide and attractive. Defining a distressed name as any security trading at a spread of 1,000 basis points ("bps") or more, only 8% of the HY universe qualifies as distressed compared to much higher levels during COVID and the energy-driven credit cycle of 2016. However, looking at the percentage of each ratings' category trading at 1,000 bps or more, bonds rated single-B and CCC are much closer to peak distress for each group. That normalizes the analysis to account for the improvement in the overall quality of High Yield over time.

Figure 2
QUALITY OF HIGH YIELD



Source: ICE BofA Indices as of 12/31/22

III. The HY Asset Class Offers Investors Higher Income with Lower Correlations to Other Asset Classes.

HY's higher income along with lower duration offers investors an attractive portfolio return/risk profile, and could fit into a portfolio as either part of the fixed income allocation or as a potential equity replacement. In fact, HY's lack of correlation to traditionally more sensitive fixed income counterparts helps to build portfolio resiliency with its ability to offer critical, income-bearing diversification (Figure 3). Such diversification ultimately lowers overall portfolio risk during the current inflationary environment. While HY has been seen as higher risk, historically HY's standard deviation has been consistently lower than equities.

Figure 3
HIGH YIELD'S LOW CORRELATION TO OTHER ASSET CLASSES CAN PROVIDE DIVERSIFICATION
12/31/17 through 2/28/23

	10 Year Treasury	Broad Market Fixed Income	Investment Grade Corporate	High Yield	S&P 500
10 Year Treasury	1.00				
Broad Market Fixed Income	0.97	1.00			
Investment Grade Corporate	0.91	0.98	1.00		
High Yield	0.55	0.72	0.83	1.00	
S&P 500	0.36	0.53	0.64	0.92	1.00

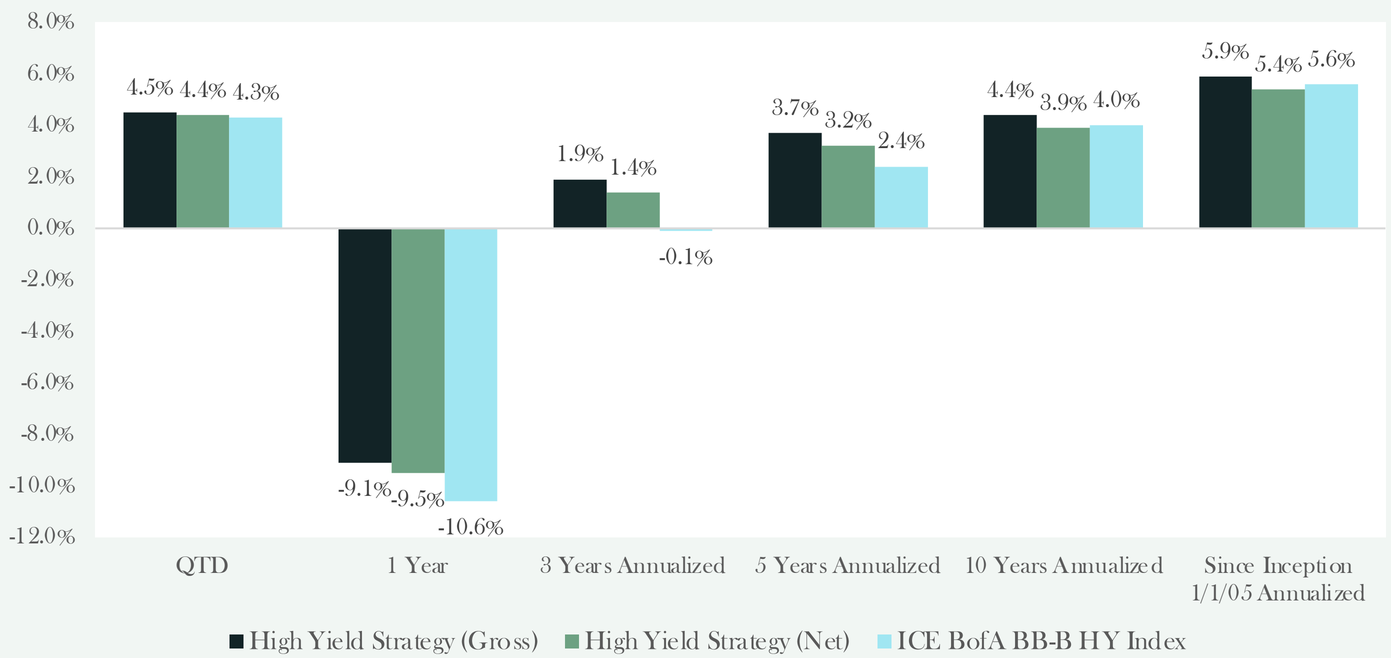
Sources: Bloomberg, ICE BofA, Standard & Poor's.

Consider Barrow Hanley's High Yield Fixed Income Strategy

Managed by an experienced team of tenured professionals, the Barrow Hanley High Yield Fixed Income strategy is designed to outperform the ICE BofA BB-B HY Index over a full market cycle. The team applies a fundamental, active, cash flow centric strategy focused on security selection to construct a high yield portfolio. The investment process is differentiated and optimized by the team's access to research and corporate management teams through Barrow Hanley's equity analysis and ownership.

HISTORICAL TRACK RECORD OF DELIVERING ALPHA

Annualized Performance as of 12/31/22



Source: APX. Returns represent an asset-weighted composite of all High Yield Fixed Income portfolios. Index returns are shown before transaction costs, management fees, and other expenses. Performance is expressed in USD currency. Net-of-fee returns are calculated using a model fee. The model fee uses the highest tier of our standard USD fee schedule. Past performance is not indicative of future results. Inception Date 01/01/05. Material presented is based on the composite and not an individual account.

Portfolio Management Team

NICK LOSEY, CFA
Portfolio Manager / Analyst

Joined the firm in 2018 | 22 years' experience

CHET PAIPANANDIKER
Portfolio Manager/Analyst

Joined the firm in 2017 | 23 years' experience

MICHAEL TRAHAN, CFA, CPA
Portfolio Manager/Analyst

Joined the firm in 2018 | 18 years' experience

Like all securities, investments in HY bonds involve risk. Some investors remain wary of the asset class despite its favorable fundamentals. Disregarding HY investments entirely could be a costly mistake, and an active manager adept at bottom-up security selection can help mitigate risks. The Barrow Hanley Credit Partners team has deep experience investing together through multiple market cycles. Additionally, the team uses the full breadth of Barrow Hanley's equity research to help identify quality companies they believe will generate attractive returns with lower risk than the HY market.

Visit us at www.barrowhanley.com to learn more about our team, investment process, and the Barrow Hanley High Yield Fixed Income strategy.

ABOUT BARROW HANLEY GLOBAL INVESTORS

Founded in 1979, Barrow Hanley is a diversified investment management firm offering value-focused investment strategies spanning global equities and fixed income. Recognized as one of the few remaining firms dedicated exclusively to value investing, Barrow Hanley enjoys a boutique culture with a singular focus to assist clients in meeting their investment objectives. Barrow Hanley stewards the capital of corporate, public, multi-employer pension plans, mutual funds, endowments and foundations, and sovereign wealth funds across North America, Europe, Asia, Australia and Africa. For further information, please visit www.barrowhanley.com.

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