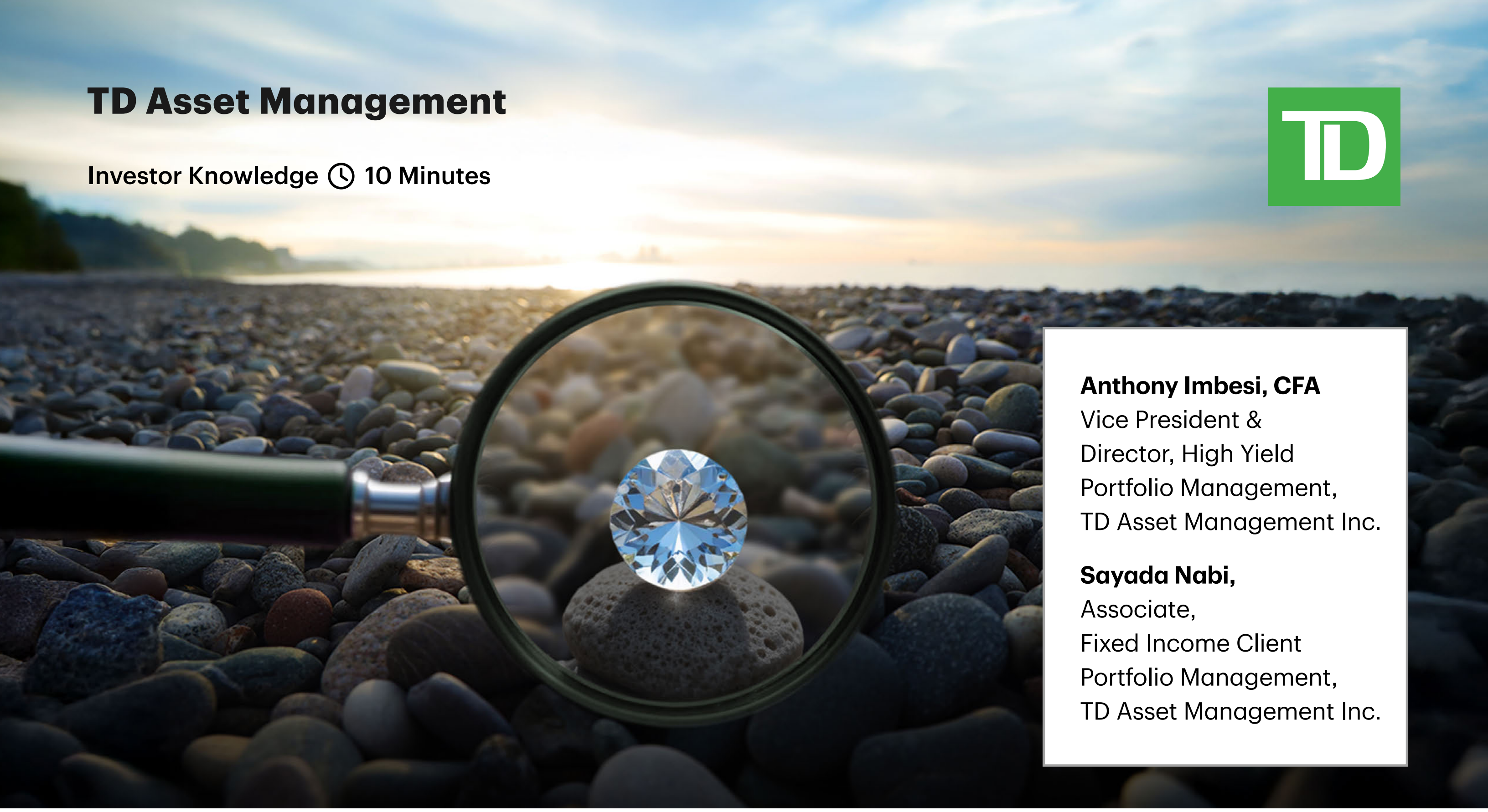
TD Asset Management

Investor Knowledge 10 Minutes



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Junk or Jewel?

A strategic case for High Yield

Fixed income investments are typically characterized for their regular, predictable income stream of coupon payments. Generally, when an investment provides income certainty, it's common for its expected return to be lower. And this is what many investors have come to both expect and accept from the 'investible' fixed income universe. What if there was a not-so secret, often overlooked, way to broaden that investment universe? It starts with rethinking what the 'investable' universe truly is.

At a glance:

- Leveraged credit, often referred to as "high yield", includes both High Yield Bonds (HY) and Leveraged Loans (LL), and deserves exploration of its potential value as a complement to traditional fixed income portfolios.
- Over the last two decades, which included periods of notable volatility, HY bonds and LL provided annualized returns of 6.4% and 4.9% respectively.
- From a risk-adjusted return perspective both LL and HY rank the highest among various fixed income asset classes, making the case for portfolio inclusion even more compelling.
- HY and LL stand out for their low correlation with other asset classes. HY bonds often show a slightly negative correlation with treasuries, while LL display an even stronger negative correlation.
- **Bottom line**: Strong annualized returns, favourable risk-adjusted performance, together with the diversification advantages, support a strategic allocation to leveraged credit within fixed income portfolios.

Introducing Leveraged Credit

Put simply, Leveraged Credit (LC) as an asset class can enhance the traditional fixed income portfolio, without excessively increasing its risk profile. LC offers unique opportunities to investors that are not provided by more traditional Investment Grade (IG) corporate or government bonds. This includes the potential for higher income, returns from capital gains, improved portfolio diversification and lower correlation to other asset classes.

Despite the integral role that LC can assume in portfolios, it's often characterized as being too risky, too volatile or low-quality, making it easy for investors to overlook. This primer explains what LC is, how it works, why it's worth considering, and what risks investors should understand before diving in.

Figure 1: Ratings scale

	Moody's	S&P	Fitch	
Investment Grade	Aaa	AAA	AAA	Decreasing Credit Risk
	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-	
Non-Investment Grade	Ba1	BB+	BB+	Increasing Credit Risk
	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	
	B2	B	B	
	B3	B-	B-	
	Caa	CCC	CCC	
	Ca	CC	CC	
	C	C	C	

Source: TDAM. For illustrative purposes only.

The basics

LC refers to corporate bonds and loans with below IG ratings. This type of debt, also referred to as high yield, speculative grade, non-IG or even "junk", has higher risk of default compared to IG debt. This risk of default is evaluated by credit rating agencies (Moody's, Standard and Poor's, Fitch) who provide an opinion and a letter rating that determines whether a company's debt is IG or not. Ratings below Baa3/BBB- (ie Ba1/BB+ or lower) are considered non-IG. LC is typically grouped into 3 categories: HY, LL and Private Credit. For the purposes of this paper, we will focus on the first two.

Meet the players: HY vs. LL

HY

HY bonds are debt securities issued by companies with below IG ratings. Their key characteristics include:

- Typically have fixed coupons.
- Shorter duration, typically mature in 5-10 years.
- Few/limited covenants.
- While most IG bonds cannot be paid down prior to maturity, HY bonds can be paid down or "called," after the expiry of a non-call period which usually ranges from 2-5 years. The company must pay a premium to bondholders for calling the bonds early.
- While less common, other HY bond features can include variable-rate coupons, interest that can be paid with more bonds instead of cash (payment in kind or "PIK") or convertibility into equity.
- Bonds can also have different levels of security or priority within a company's capital structure, which will become important in the event of a restructuring or default.

LL

Like HY bonds, LL are loans with below IG ratings. However, loans have unique characteristics that differentiate them from bonds:

- LL are generally secured and rank higher in a company's capital structure. This higher priority reduces risk by improving the recovery value to lenders versus other unsecured lenders in the event of a default.
- LL coupons are also variable, typically providing a spread or margin over a referenced benchmark such as the Secured Overnight Financing Rate (SOFR). These coupons reset every 1-3 months effectively giving loans near zero duration or very low-interest rate sensitivity.
- LL have less call protection than HY bonds and newly issued loans generally have a 6- or 12-month 101 soft call protection forcing the company to pay a 1% premium or "penalty" for paying down or refinancing its loans. After the call protection period expires, the loans can be repaid or refinanced anytime without penalty exposing the lender to re-investment risk.

A limitation of investing in LL is that they are only available to institutional buyers and retail investors can only get exposure to loans via funds that invest in them.

Figure 2: Capital structure security ranking

	Priority	Rank	Security Type	
Debt	Highest	Senior Secured	Bonds, Loans, Private Credit	High Yield
	↑	Senior Unsecured	Bonds, Private Credit, Convertible	
		Senior Subordinated	Bonds, Convertible	
		Junior Subordinated	Bonds, Convertible, Hybrids	
		Subordinated	Bonds, Convertible, Hybrids	
Equity	↓	Preferred Equity	Cumulative, Non-Cumulative	
	Lowest	Common Equity	Voting, Non-Voting	

Source: TDAM. For illustrative purposes only.

The market: Likely bigger than you think

HY

Prior to its development in the early-1980s into the market that we know today, HY primarily consisted of "fallen angels", bonds that originally were IG but had been downgraded to HY. By the mid-1980s HY bond new issuance began to increase amid growth in the leveraged buyout (LBO) market, creating a market of $50Bn in size. Today the U.S. dollar denominated HY bond market is the world's largest at ~$1.4 Trillion. This represents ~1,900 securities from nearly 900 issuers across a range of industries. When combined with euro-denominated (~$400 Billion) and emerging markets (~$400 Billion) HY, the global HY bond market is ~$2.2 Trillion in size[1].

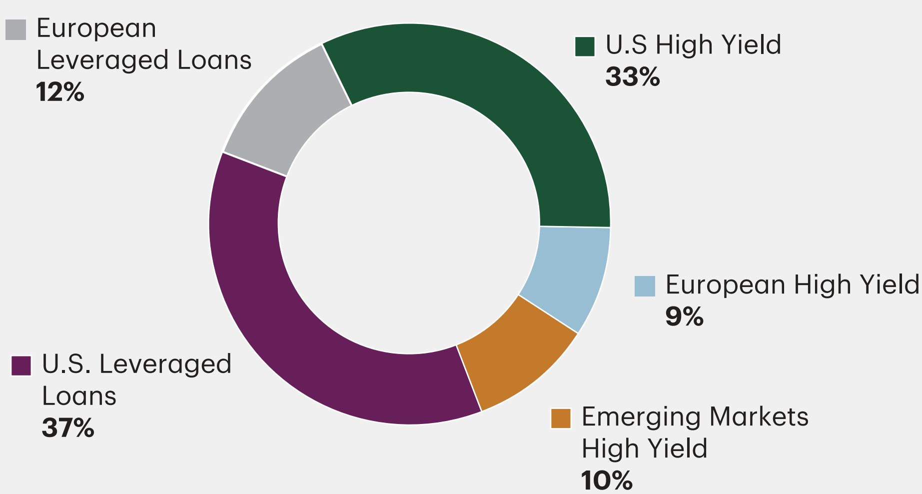
The HY bond market has been an important contributor of income to both institutional and individual investors over the years. Dedicated HY open-ended funds own about 22% of the HY market and comprises about 47% when other non-HY funds are included. Other major investors of HY bonds include Insurance companies (24%), pension funds (15%) and alternative asset managers (10%)[2].

LL

Until the mid-1980s LL were primarily originated and held to maturity by commercial banks' lending to their corporate clients and as such, were underwritten conservatively. With the surge in leveraged buyout (LBO) activity of the 1980s, these loans became increasingly larger in size and banks began offering these loans to institutional investors to limit below IG credit exposure on their balance sheets. By the 1990s investment banks started providing markets, and therefore liquidity, to facilitate the need for institutional investors to trade these loans, and this gave way to a secondary market. As the secondary market grew, banks transitioned from originating and holding loans to earning fees for underwriting and syndicating loans which ultimately evolved into today's broadly syndicated loan (BSL) market.

The U.S. Dollar and Euro-denominated loan markets are about ~$1.5 Trillion and ~$500 Billion in size respectively which, when combined with the HY bond market, collectively brings below IG corporate debt market to about ~$4.1 Trillion in size[3]. The primary buyer of LL are collateralized loan obligation (CLO) funds which hold about two-thirds of outstanding loans.

Figure 3: Corporate leveraged finance market



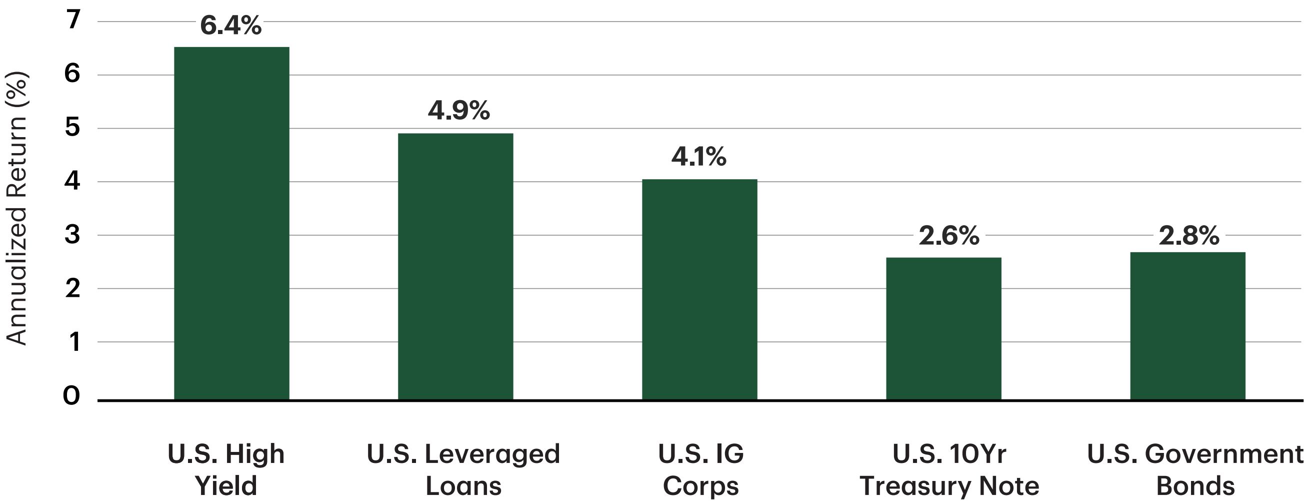
Source: Bloomberg Finance L.P., UBS. Data as of June 30, 2025. U.S High Yield is represented by the ICE BofA U.S. High Yield Index; European High Yield is represented by the ICE BofA. Euro High Yield Index, Emerging Markets High Yield is represented by the ICE BofA High Yield Corporate Plus Index, U.S. Leveraged Loans is represented by the S&P UBS Leveraged Loan Index and European Leveraged Loans is represented by the S&P UBS European Leveraged Loan Index.

Why invest in LC?:

Attractive (risk-adjusted) returns

Historically the HY market has generated superior returns when compared to other publicly traded fixed income asset classes. Over the last two decades, a period which includes the Global Financial Crisis, The Covid-19 Pandemic, and the recent high inflationary environment with elevated interest rates, the HY market has provided an annualized return of 6.4% while the U.S Dollar LL market returned 4.9% per annum.Both asset classes surpassed the annualized returns of IG corporate bonds (4.1%), U.S. 10 Year Treasury (2.8%) and US Government bonds (2.6%) over the same period[4]. (**Figure 4**)

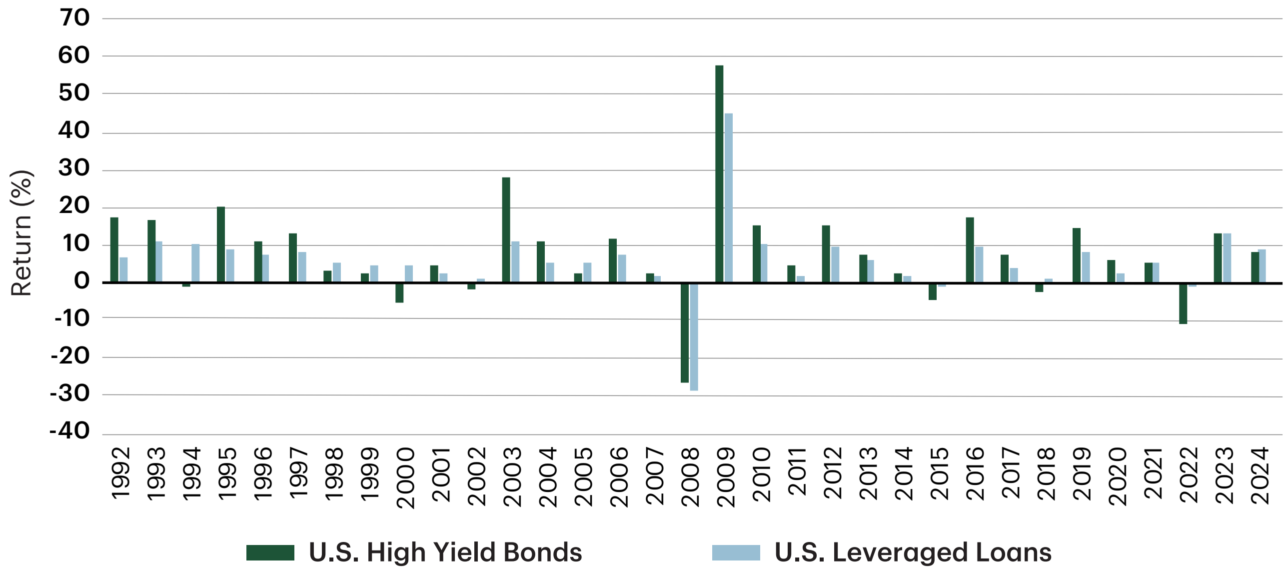
Figure 4: Total returns over the past 20 years



Source: Bloomberg Finance L.P. Data as of June 30, 2025. U.S. High Yield is represented by the ICE BofA U.S. HY Index, U.S. Leveraged Loans is represented by the S&P UBS Leveraged Loan Index, U.S. IG Corps is represented by the ICE BofA U.S. Corporate Index and U.S. Government Bonds is represented by the ICE BofA All Maturity U.S. Government Index.

Historical calendar year returns through economic cycles and recessions illustrate the magnitude of gains and losses over the years. Since 1992 HY bonds and loans have had positive calendar year returns 79% and 91% of the time. Moreover, they have not subjected investors to two consecutive years of negative performance. Dissecting these returns a step further, HY bonds and loans also produced double digit annual returns 42% and 15% of the period respectively[5]. (**Figure 5**)

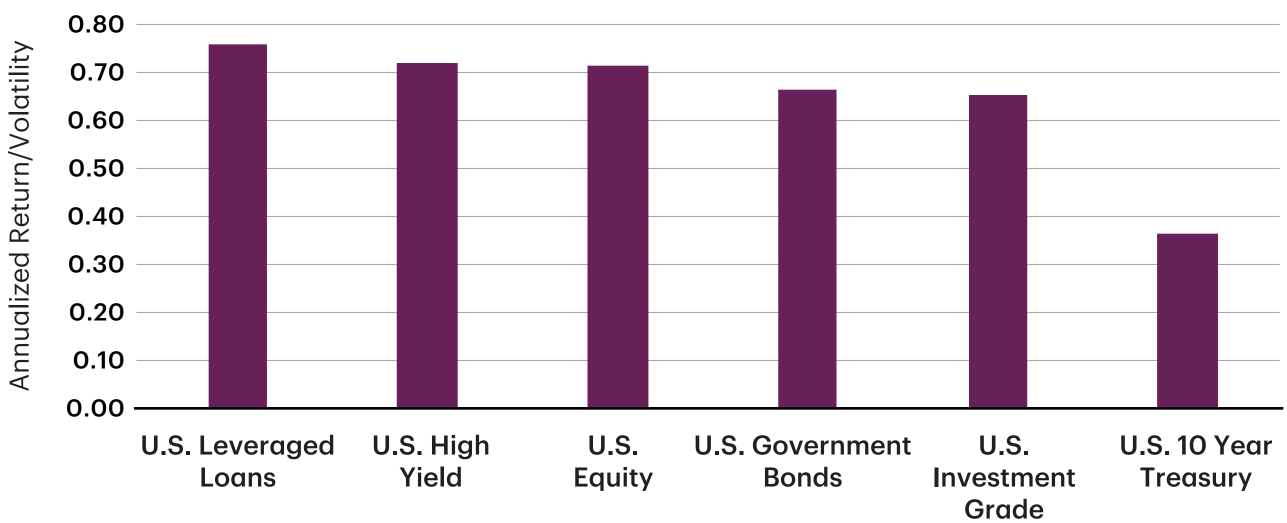
Figure 5: High Yield Bonds and Leveraged Loans Calendar year returns



Source: Bloomberg Finance L.P, UBS. Data as of June 30, 2025. U.S High Yield Bonds is represented by the ICE BofA U.S. HY Index and U.S Leveraged Loans is represented by the S&P UBS Leveraged Loan Index.

When we bring volatility into the conversation, LC returns are just as compelling. The graph (**Figure 6**) below shows that when we rank asset classes by comparing the risk taken to achieve their return, LL and HY come up on top.

Figure 6: 20-year risk adjusted return



Source: Bloomberg Finance L.P. Data as of June 30, 2025. Annualized returns divided by standard deviation; 20-years ended Feb 28, 2025. U.S. Leveraged Loans is represented by the S&P UBS Leveraged Loan Index, U.S. High Yield is represented by the ICE BofA U.S. High Yield Index, U.S. Equity is represented by the S&P TR 500 IIndex, U.S. Government Bonds is represented by the ICE BofA All Maturity U.S. Government Index, U.S. Investment Grade is represented by the ICE BofA U.S. Corporate Index and U.S 10 Year Treasury is represented by the U.S. 10Yr Treasury Note.

Low correlation: Diversification benefits

Another benefit to LC is its low correlation of returns to other asset classes. Given credit fundamentals drive the majority of HY bonds and loans performance, the asset classes have low correlation with more interest rate sensitive fixed income. HY bonds even have a slightly negative correlation to treasuries with loan correlation even more negative. (**Figure 7**)

Figure 7: U.S High Yield correlation - 25 year period

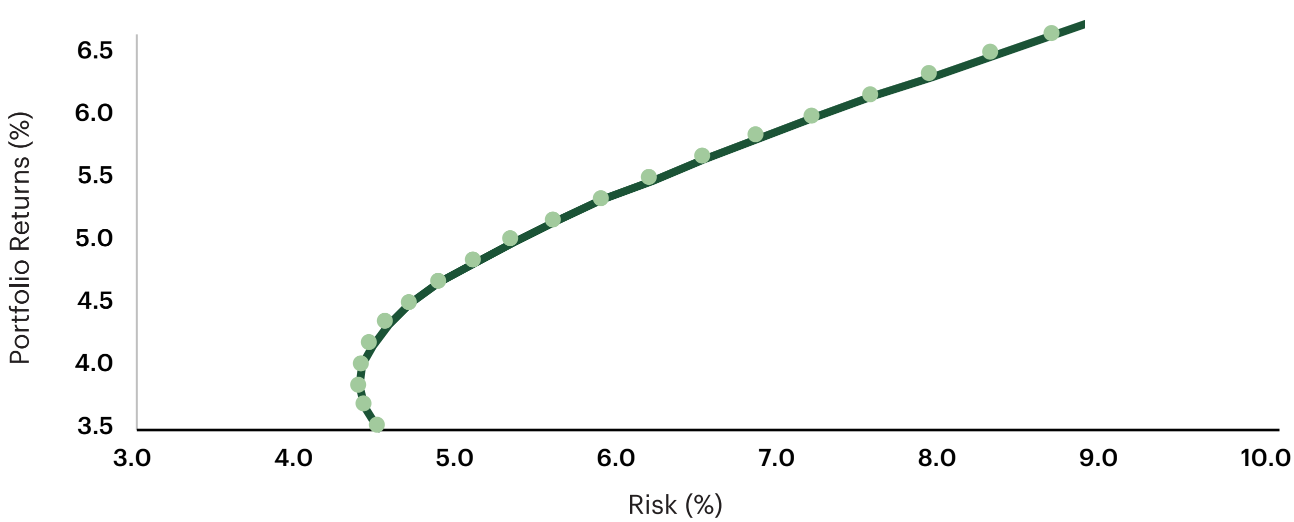
	U.S High Yield Bonds	U.S. Leveraged Loans
Global High Yield Bonds	0.99	0.80
U.S Leveraged Loans	0.78	–
U.S IG Corporate Bonds	0.61	0.41
Canadian IG Corporate Bonds	0.43	0.33
U.S. 5 Year Treasuries	(0.08)	(0.31)
U.S. 10 Year Treasuries	(0.05)	(0.30)
3 Month Treasury Bill	(0.10)	(0.09)
S&P 500 Index	0.69	0.53

Source: Bloomberg Finance L.P. Data and correlation as of June 30, 2025. U.S High Yield is represented by ICE BofA U.S. High Yield Index, U.S. Leveraged Loans is represented by the S&P UBS Leveraged Loan Index, U.S. Global High Yield Bonds is represented by the ICE BofA Global High Yield Index, U.S IG Corporate Bonds is represented by the ICE BofA U.S. Corporate Index, Canadian IG Corporate Bonds is represented by the ICE BofA Canada Corporate Index, U.S. 5 Year Treasuries is represented by the ICE BofA Current 5-year Treasury Index, U.S. 10 Year Treasuries is represented by the ICE BofA Current 10-year Treasury Index and the 3 Month Treasury Bill is represented by the ICE BofA U.S. 3-Month Treasury Bill Index.

Given that LC is less correlated to interest rate movements than IG credit, due to their shorter duration and higher credit spread component, their performance is more aligned with economic growth and corporate health—i.e. credit fundamentals. This implies that the inclusion of HY or LL to a traditional IG fixed income portfolio can lower overall volatility and provide more diversified performance which can help mitigate interest rate risk.

Bottom line: it can maximize return along the efficient frontier which is the set of optimal portfolios that offer the highest expected return for a defined level of risk or the lowest risk for a given level of expected return. (**Figure 8**).

Figure 8: Maximizing returns along the efficient frontier



Source: Bloomberg Finance L.P. Data as of June 30, 2025.

Risks: What investors should understand

As is often the case, there are higher risks associated with earning higher returns and LC is no exception. The primary risk of investing in LC is credit risk which must be managed properly to maximize the potential returns offered by the asset class. **No investment is risk-free, and LC comes with trade-offs:**

Default risk is the probability that a company fails to make contractually obligated payments on its debt – either scheduled coupon/interest or principal at time of maturity. The default rate, or amount of principal that defaults as a percentage of the overall market over a one-year period, tends to be highest during recessions, periods of deteriorating credit fundamentals and constrained funding liquidity.

Recovery risk is the amount of capital loss sustained from a default. While there is usually some amount of residual value remaining to debt holders from a restructuring, the ultimate recovery amount will depend on the overall valuation of the business and where in the capital structure the debt ranks. Generally, the average long-term recovery for HY bonds and LL has been approximately 40% and 65% respectively but can be higher or lower depending on each situation. Recoveries can include receiving an equity stake in the newly restructured company, the upside of which can ultimately contribute to even greater recoveries depending on the post-bankruptcy restructuring performance of the company.

Downgrade risk is the probability of a credit ratings downgrade due to deteriorating fundamentals of the company. As an example, declining operating performance or increased borrowing could weaken a company's ability to service its debt and increase its risk of default, likely resulting in a downgrade. Markets are usually efficient in pricing credit risk and a bond's price would decline prior to a rating downgrade. However, unless fundamentals continue to deteriorate, bondholders will not experience a permanent loss but a shorter-term mark-to-market decline in price. A company can continue to meet its interest payments and eventually repay or refinance its principal, resulting in a full recovery.

Liquidity risk is the ability to trade or transact in a given time without impacting the market price of the security. The HY and LL markets can be relatively illiquid compared to other asset classes. In good market conditions, average bid-ask spreads can range from $0.25-0.50 of dollar price for bonds that trade regularly. Under times of market stress, the bid-ask can average $0.75 for more liquid bonds and be even wider for less liquid bonds with the latter trading very infrequently if at all.

Interest rate risk is the sensitivity of bond prices to changes in interest rates. HY bonds have fixed coupons which subject them to interest rate risk but with lower sensitivity than other non-HY bonds (IG bonds). HY bonds generally have shorter maturities (less than 10 years), are callable well before their maturities and have higher coupons which gives the HY index much lower duration than the IG index. As mentioned previously, credit fundamentals tend to drive most of the performance in HY bonds and LL.

Final take: Not junk, just misunderstood

LC should not be viewed as a speculative or risky asset class but more as an integral component of a fixed income toolkit. Its benefits of better risk-adjusted returns and lower correlations can improve outcomes for a fixed income portfolio keeping in mind that the longer the investment horizon, the better the ability to benefit from the strong attributes of the asset class.

For investors seeking income, higher total return potential and improved portfolio diversification, LC deserves serious consideration. In addition, investors should have a good understanding of both the potential rewards and the risks involved and should consider investing with an experienced, active manager to have the best outcomes. ■

[1] Bank of America, May 26, 2023.

[2] Bank of America, March 31, 2025. Dedicated Funds: 22%, Core+/Flex Funds: 25%, Pension Funds: 15%, Insurance Cos: 24%, Alt Managers: 10%, Banks CLOs: 1%, Retail: 3%.

[3] Bloomberg Finance L.P, UBS, June 30, 2025.

[4] Bloomberg Finance L.P, June 30, 2025.

[5] Bloomberg Finance L.P, June 30, 2025.

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