

# Higher-Quality High Yield Asset Allocations

## *Achieving Income Objectives Through a Risk-Managed Approach*

The quest for income has grown increasingly complex for many investors, particularly more conservative ones. Globally, low interest rates and a flight to quality have led to short-term U.S. Treasury yields of essentially zero percent, whilst government bonds from other perceived “safe havens” (for example, Germany and Switzerland) provide negative yields. However, as a slow, uneven economic recovery could exert pressure on issuers of the highest yielding, most speculative credits, moving far down the quality spectrum for a near-term yield pick-up won’t be the best course for many investors, either.

We believe these considerations support the case for utilising a higher-quality high yield strategy to diversify and increase the income potential of a core fixed income allocation, and to reduce the credit risk of a lower-grade high yield allocation.

### **Compelling Fundamentals In the High Yield Market**

Several factors support our constructive view of high yield corporate bonds. Credit spreads are attractive and compare favourably with defaults. Corporate bonds have fundamentally improved since the credit crisis, driven primarily by three factors that we see continuing.

1. A low interest-rate environment has spurred a massive refinancing of corporate debt. In addition to reducing the cost of borrowing, this has also allowed companies to extend debt maturities and reduce near-term financing needs.

2. This refinancing, along with strong operating performance, has led to significantly improved credit metrics for many high yield credits. For example, leverage for U.S. high yield issuers has declined substantially since peaking in 2009.

3. Although economic growth since 2008 has been modest, corporate revenues are now back to pre-crisis levels.

### **Hedging Against Rising Rates**

Extremely accommodative monetary policies from central banks have become the norm, but this level of support cannot continue into perpetuity. Whilst the general consensus is that a rapid rise is not likely over the near term, even a modest move in rates could have a major impact on low-yielding Treasuries and other high-quality fixed income assets. An allocation to high-yield securities can help reduce the interest rate sensitivity of a core fixed income allocation.

### **Why a Higher-Quality Approach to High Yield?**

Although we see improving high yield fundamentals, the muted global economic recovery requires a higher degree of care in the portfolio construction process. Whilst defaults are currently low, they do occur; and a short-term boost in income cannot make up for the longer-term problems of a default. Our view is that mid-grade credits currently offer a compelling balance of risk versus return. Notably, research from Barclays Capital shows that U.S. mid-grade issues have outperformed the most speculative credits in periods of slower GDP growth.



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Our higher-quality approach to high income contrasts with many other high yield managers. We seek improving companies that still offer an attractive yield. We emphasise companies with high return on invested capital, reliable debt servicing, capable management and a potential catalyst that could lead to a credit upgrade. To understand the pressures a company could face, we value businesses in the downward phase of the credit cycle. We typically avoid complex business models, workouts and the most speculative credits. In our view, owning the weakest credits simply to pursue the highest yield makes a portfolio too reliant on robust economic growth and subjects it to unnecessary risk.

For more information, please read our recent white paper, available at [calamos.com/HighYield](http://calamos.com/HighYield).

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