Fallen Angel Bonds: Resurrecting Value in High Yield

In this Q&A, Fran Rodilosso, Head of Fixed Income ETF Portfolio Management at VanEck, discusses what sets fallen angel high yield bonds apart from the broad high yield universe and why investors should be paying attention to this unique segment.

What are fallen angel high yield bonds?

Fallen angel bonds are part of the overall high yield universe but unique in that they were originally issued with investment grade ratings and later downgraded to non-investment grade, or high yield. This results in differentiating characteristics versus the broader high yield bond market—such as, a higher average credit quality—and the crossover from investment grade to high yield markets is where the value proposition of fallen angels originates. The investor bases for these two markets have distinct objectives, risk constraints and investment policy statements. When a bond is downgraded to high yield, investment grade investors who cannot, or will not, hold a high yield bond must sell it, which can impact its value. The market tends to anticipate rating actions, so bonds are typically sold and prices driven down prior to the downgrade. Historically, prices have tended to recover fully during the six months, on average, following the downgrade.

This forced selling phenomenon and the higher quality tilt have driven long-term outperformance of fallen angels versus the broad high yield market.[1] In addition, fallen angels provide differentiated sector exposure versus the broad market. Downgrades are often concentrated in certain sectors, which allows a fallen angel strategy to be overweight oversold sectors where fundamentals have bottomed out, and benefit from a potential recovery. The result has been an average of 250 basis points of outperformance versus the broader U.S. high yield market per year over the past 10 years, including outperformance in 11 of the last 15 calendar years.[2]

Can investors anticipate fallen angels? Are there conditions today that could be influencing factors?

At an individual issuer level, the market does tend to anticipate downgrades, as seen in the bond price prior to downgrade. In general, a bond will be downgraded if a credit rating agency believes the probability of default has increased. Reasons for this may include management decisions around leverage, mergers and acquisitions, macro trends—such as declining industries or industries where competition has cut into margins—or a combination of factors. Following the dramatic decline in oil and commodity prices that began in 2014, we saw a significant number of energy-related fallen angels.

Predicting the exact timing of the next wave of downgrades or the sectors that will be most impacted is challenging. The volume of fallen angels has been quite low in recent years due to a tremendous amount of liquidity in the markets in recent years and the longest economic expansion in U.S. history. When these conditions are no longer present, and when credit tightens, we think that will likely be the catalyst for the next wave of downgrades. Investment grade companies with the most leverage and reliance on re-financing will be most vulnerable.

How do fallen angels fit within a portfolio given where we are in the market cycle?

Credit spreads are wider than a year ago, but still tight versus historical averages. Given where we are in the credit cycle, corporate and high yield bond investors are, understandably, a little nervous. But investors still need income, and the challenge is to find it without taking excessive risk in this extremely low interest rate environment. Many investors have strategic, dedicated high yield exposure and are looking for ways to mitigate potential risk in their portfolio without sacrificing carry. We think fallen angels present an attractive solution because they provide many of the qualities that income investors need in a late-cycle market environment: attractive carry, higher quality and a value-oriented approach.

Historically, environments where the amount of fallen angels spikes—typically after the cycle has turned—have been associated with outperformance of fallen angels versus the broad U.S. high yield market.[3] The more bonds investors can buy at attractive prices, the more that benefits performance, on average. In addition, higher quality bonds tend to have lower drawdowns in periods of stress and have historically experienced lower default rates.[4] The yield on fallen angels is currently in line or higher than other broad U.S. high yield indices, including those which some of the largest high yield ETFs track, so moving up in credit quality does not mean sacrificing yield.[5]

How can investors access the fallen angel high yield bond market?

Fallen angels comprise only 10% of the broader high yield market and currently total over $100bn in market value.[6] We think a rules-based approach, such as the VanEck Vectors® Fallen Angel High Yield Bond ETF (ANGL), can be an efficient way for income investors to access this segment of the market.

Since inception, ANGL has outperformed its Morningstar category average by over 300 basis points, as of 9/30/19, placing it at the top of the category.[7] The Morningstar category is US Fund High Yield Bond. For the 5 year period ending 9/30/19, ANGL is ranked #1 out of 527 funds based on total return. From inception of 5/1/2012, ANGL total return is 8.15% per annum vs the average category total return of 5.03%. It has also outperformed active high yield bond strategies as measured by the Morningstar High Yield Bond category average over the same time period.[8] This is a contrarian strategy that buys bonds that others are selling and goes overweight sectors that have hit rock bottom. We believe, it would take a tremendous amount of conviction for an active manager to apply this strategy with such discipline, particularly in stressed market conditions.

Higher Quality High Yield

Fallen angels, or high yield bonds originally issued as investment grade corporate bonds, may provide a distinct value proposition that sets them apart from the broad high yield market. ANGL is a first-of-its-kind ETF offering exposure to this differentiated asset class.

Higher Credit Quality[9]	Outperformed Broad High Yield Bond Market[10]	Sector Differentiation[11]

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IMPORTANT DISCLOSURE

[1] Source: ICE Data Services. Based on the performance of the ICE BofAML US High Yield Index and the ICE BofAML US Fallen Angel High Yield Index from 12/31/2003 to 9/30/2019.

[2] Ibid.

[3] Ibid.

[4] Source: ICE Data Services. Based on the par amount of bonds that have defaulted annually in the ICE BofAML US Fallen Angel Index and the ICE BofAML US High Yield Index from 12/31/2003 to 9/30/2019.

[5] Source: ICE Data Services and VanEck. Data as of 9/30/2019.

[6] Source: ICE Data Services. Based on the total market value of the ICE BofAML US Fallen Angel Index and the ICE BofAML US High Yield Index. Data as of 9/30/2019.

[7] Source: Morningstar.

[8] Source: Factset. Data as of 9/30/2019.

[9] Fallen angels have had historically higher average credit quality than the broad high yield bond universe when comparing the ICE BofAML US Fallen Angel High Yield Index and ICE BofAML US High Yield Index. ICE Data composite ratings are simple averages of various rating agencies, and are not intended to be a credit opinion.

[10] Fallen angels have outperformed the broad high yield bond market in 11 of the last 15 calendar years. Source: FactSet. Represented by the ICE BofAML US Fallen Angel High Yield Index ("Index") and the ICE BofAML US High Yield Index ("Broad HY Index"), respectively.

[11] Based on the credit quality and sector exposures of the ICE BofAML US Fallen Angel High Yield Index (H0FA) compared to the ICE BofAML US High Yield Index (H0A0), as of 8/31/2019. Past performance is not a guarantee of future results. Performance current to the most recent month end is available by calling 800.826.2333.

An investment in the VanEck Vectors® Fallen Angel High Yield Bond ETF (ANGL®) may be subject to risk which includes, among others, high yield securities, foreign securities, foreign currency, credit, interest rate, restricted securities, market, operational, call, sampling, basic materials, energy, financial services, telecommunications, index tracking, authorized participant concentration, no guarantee of active trading market, trading issues, passive management, fund shares trading, premium/discount and liquidity of fund shares and concentration risks, all of which may adversely affect the Fund.

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Index returns are not Fund returns and do not reflect any management fees or brokerage expenses. Certain indices may take into account withholding taxes. Investors can not invest directly in the Index. Returns for actual Fund investors may differ from what is shown because of differences in timing, the amount invested and fees and expenses. Index returns assume that dividends have been reinvested.

ICE BofAML US Fallen Angel High Yield Index (H0FA, "Index"), formerly known as BofA Merrill Lynch US Fallen Angel High Yield Index prior to 10/23/2017, is a subset of the ICE BofAML US High Yield Index (H0A0, "Broad Index"), formerly known as BofA Merrill Lynch US High Yield Index prior to 10/23/2017), including securities that were rated investment grade at time of issuance. H0FA is not representative of the entire fallen angel high yield corporate bond market.

Fund shares are not individually redeemable and will be issued and redeemed at their NAV only through certain authorized broker-dealers in large, specified blocks of shares called "creation units" and otherwise can be bought and sold only through exchange trading. Shares may trade at a premium or discount to their NAV in the secondary market. You will incur brokerage expenses when trading Fund shares in the secondary market. Past performance is no guarantee of future results. Returns for actual Fund investments may differ from what is shown because of differences in timing, the amount invested, and fees and expenses.

The "Net Asset Value" (NAV) of a VanEck Vectors Exchange Traded Fund (ETF) is determined at the close of each business day, and represents the dollar value of one share of the fund; it is calculated by taking the total assets of the fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV is not necessarily the same as the ETF's intraday trading value. VanEck Vectors ETF investors should not expect to buy or sell shares at NAV.

Investing involves substantial risk and high volatility, including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise. An investor should consider the investment objective, risks, charges and expenses of a fund carefully before investing. To obtain a prospectus and summary prospectus, which contain this and other information, call 800.826.2333 or visit vaneck.com. Please read the prospectus and summary prospectus carefully before investing.

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