Tread carefully with junk bond funds

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Over the past year, high-yield fixed-income funds have produced high anxiety for investors. These are funds whose holdings consist largely or entirely of lower-quality corporate credits referred to as "below investment grade." Or more disparagingly, they're known as junk bonds.

Most bond funds that hold investment grade securities achieved positive returns last year, providing a very welcome offset to the bleeding sustained by equity funds.

Not high-yield funds, which are something of a hybrid between equity and fixed-income products. The median loss for these funds was 17.3 per cent in 2008, and about the only good thing you can say about that is most equity funds fared much worse.

Though the high-yield category recovered in January with a median return of 2.6 per cent, there is a rough road ahead. Globally, we still have a credit crisis, a recession and a bear market. It's the type of environment that heightens the risk of deadbeats in a segment of the fixed income market whose returns depend on the creditworthiness of individual companies.

Default rates on high-yield bonds are likely to get worse before they get better, according to Phillips Hager & North Investment Management Ltd., which manages one of the best performing high-yield funds. The Vancouver-based firm expects corporate default rates to rise "very materially" this year and on into 2010.

Even so, PH&N believes the selloff of high-yield bonds has been overdone. As prices of these bonds get marked down, there is a widening gap between their yields and the yields on very creditworthy bonds such as Government of Canada issues.

This gap is known as the yield spread and it represents the premium investors are paid for taking on the risk of defaults. "At current spreads, investment grade and high-yield bonds now price in an economic forecast as dour as the 1930s Great Depression," according to PH&N, which says it is gradually building positions in some higher-quality high-yield issues.

High-yield bond funds vary in their credit quality. The Canadian Investment Funds Standards Committee defines fixed- income funds as high yield if the average credit quality is below investment grade, or if at least 25 per cent of the holdings are below this same threshold.

Accordingly, funds in the category can range from riskier pure plays to those that are holding up to three-quarters of their assets in investment grade securities.

Morningstar Canada fund analysts have three current favourites among high-yield mutual funds: PH&N High Yield Bond, Trimark Global High Yield Bond and TD High Yield Income.

PH&N High Yield Bond, among the fund category's more conservative offerings, invests mainly in Canada.

By contrast, the funds managed by TD Asset Management Inc. and Invesco Trimark Ltd. are pure high-yield plays. Their greatest exposure is to bonds issued by companies in the United States, where the high-yield market is much larger than in Canada.

The purer the higher-yield play, the worse the returns are likely to be in a bear market. While the PH&N fund eked out a 0.4 per cent return in the 12 months ended Jan. 31, the Trimark fund lost 21.9 per cent and the TD fund was down 36.1 per cent.

If losses like these leave you with a queasy feeling, your best approach to high-yield funds is simply to avoid them. For more growth-oriented investors, however, professionally managed exposure to high-yield bonds is worth considering. Think of them as the aggressive portion of your fixed-income holdings. Alternatively, they can be viewed as a somewhat more conservative way to participate in a business recovery.

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