HIGH YIELD:
WHY YOU STILL NEED IT

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Point of View With Jim Keenan

From December of 2008 (near the end of the financial crisis) through 2012, high yield bonds were one of the world's best-performing asset classes, with an annualized return of 22%. The next best performer, emerging markets equity, returned 19.7%. Notably, high yield's outperformance was achieved with 40% of the volatility of EM equities and 58% of the volatility of US stocks, which returned an annualized 14.6%.* Partly as a result of this success, the yield to worst of a high yield bond is near a record low, while the average price is near its all-time high. This has many investors asking whether it is time to lock in profits and move on. Jim Keenan, head of BlackRock's Leveraged Finance Group and lead high yield portfolio manager, believes the asset class is still very attractive and should remain a strategic allocation within investor portfolios. Consider this:

- Slow but positive growth, low interest rates, and monetary accommodation by major central banks has fueled demand for higher-yielding assets. We expect this scenario to persist through 2015.
- The low absolute yields and high prices of high yield bonds are mostly the result of record-low interest rates. On a relative basis, high yield is very attractive versus Treasuries, particularly given low expected default rates.
- With the average high yield company in good credit condition, upcoming maturities low, and demand for yield high, we expect defaults to remain low and investors to be generously compensated for credit risk.

High yield was up almost 16% in 2012. What propelled the market?

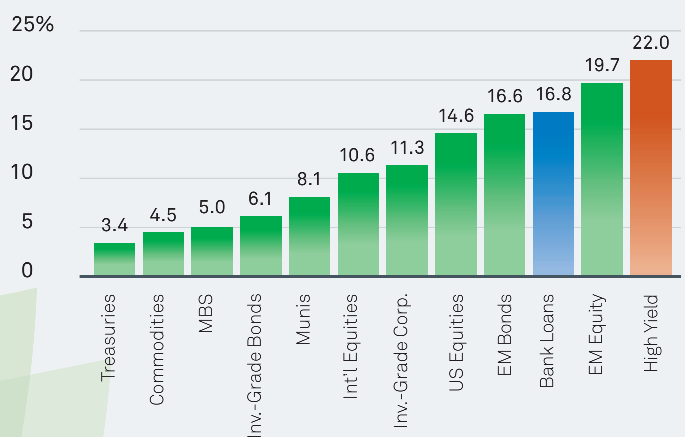
The world is still in the midst of a long deleveraging process where public policy, both monetary and fiscal, has been important in reducing the risk of a systemic shock and helping to mitigate the drag on global growth. In 2012, these concerted efforts led investors to reduce the probability they assigned to such a shock and, therefore, the premiums they required to invest in global "risk" markets (e.g., high yield bonds, equities). This more optimistic view led to a very strong year for risk assets, including high yield.

* High yield returns represented by the Barclays US Corporate High Yield Index, EM equity returns by the MSCI Emerging Markets Index and US stock returns by the S&P 500 Index.

James Keenan, CFA, is a Managing Director and Head of BlackRock's Leveraged Finance Group, which is responsible for more than $41 billion in high yield and bank loan portfolios. Mr. Keenan also is the lead portfolio manager for high yield portfolios, including the flagship BlackRock High Yield Bond Fund. Mr. Keenan, who has worked in the high yield market for more than 14 years, joined BlackRock in 2004. He has also worked in the high yield groups at Columbia Management and UBS Global Asset Management.

HIGH YIELD: A FOUR-YEAR STANDOUT

Total Returns, 2008 to 2012



Sources: BlackRock, Barclays Capital, MSCI, Standard & Poor's, JP Morgan. As of December 31, 2012. Treasuries represented by the Barclays US Treasury Index; commodities by the Dow Jones-UBS Commodity Index; MBS by the Barclays Agency Fixed Rate MBS Index; investment-grade bonds by the Barclays US Aggregate Index; municipal bonds by the Barclays Municipal Index; international equities by the MSCI EAFE Index; investment-grade corporates by the Barclays US Corporate Investment Grade Index; US equity by the S&P 500 Index; emerging markets bonds by the JP Morgan Emerging Market Bond Index Global; bank loans by the S&P Leveraged Loan Index; emerging markets equities by the MSCI Emerging Markets Index; high yield by the Barclays US Corporate High Yield Index. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

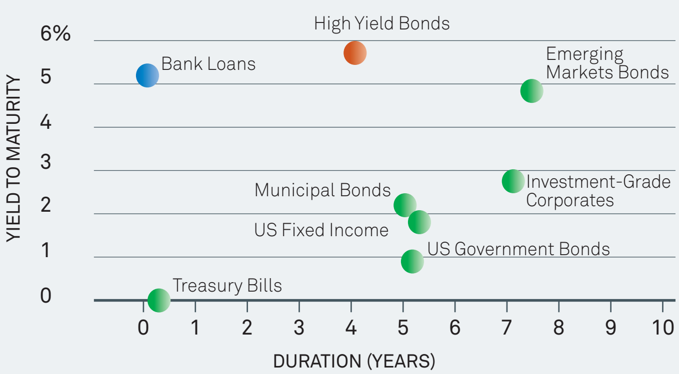
In addition, we observed strong and improving credit conditions among the companies in which we invest. This also bolstered the market, as did the continued thirst for yield driven by record-low interest rates. Ultimately, this drove about $30 billion into high yield funds last year.

After 4+ strong years, is there anything left? Is high yield overheated or just plain too expensive?

The general level of interest rates is set by the Treasury market, and this informs the risk premium (the spread over Treasuries) that investors are willing to pay for high yield. In other words, the high yield market is priced relative to everything around it. High yield is trading near record price and yield levels today because Treasury yields are near record lows, not because the high yield market is overheated.

On a relative basis, high yield still looks attractive to us. At a spread over Treasuries of about 470 basis points (bps), high yield is almost twice the record low of 250 bps over set in 2007. It is also about 150 bps cheaper than the levels you would normally see when defaults are 2% or below, as they are now and should likely remain through 2014. We're all familiar with the risks of high yield investing (i.e., non-investment-grade debt securities can be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories). In the current environment, however, we think investors are being well paid for relatively low default risk in high yield. Meanwhile, many of the perceived "safe" investments in the investment-grade space aren't paying investors enough for interest rate risk when you consider a modest rise in interest rates can wipe out a year of coupon, producing a net loss.

HIGH YIELD AND BANK LOANS POSITIONED TO OUTPERFORM WHEN RATES RISE



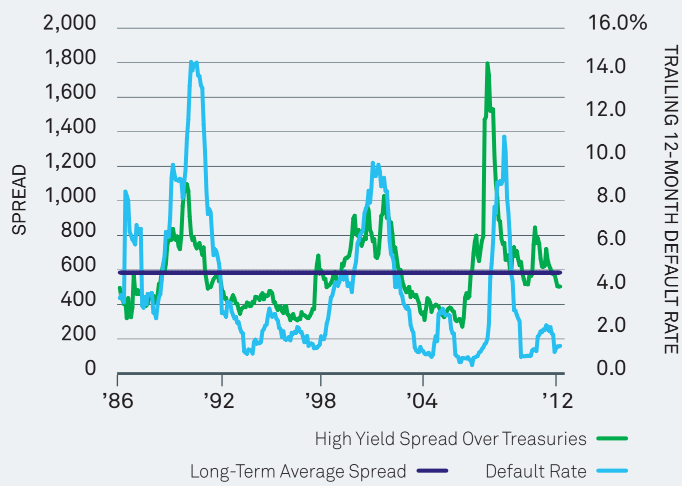
Sources: Barclays, BlackRock, Bloomberg, JP Morgan, S&P/LSTA. Data as of March 31, 2013. EM Bonds represented by the JP Morgan EMBI Global Index; bank loans by the S&P All Loan Index; US government bonds by the Barclays Capital (BarCap) US Government Bond Index; high yield bonds by the BarCap US High Yield Corporate Index; US fixed income by the BarCap US Aggregate Bond Index; investment-grade bonds by the BarCap US Investment Grade Corporate Index; municipals by the BarCap Municipal Bond Index. It is not possible to invest directly in an index. Past performance is no guarantee of future results. Correlations calculated using monthly total returns dating back 10 years.

We've seen this already in the first few months of 2013. And cash, the ultimate "safe haven," earns a negative return after inflation. So, we believe investors need to consider what types of risk they want to own. There's credit risk (i.e., the possibility that the bond issuer will not be able to make principal and interest payments), but there's also duration risk. If you want deflation protection in your portfolio, own US Treasuries or cash. But if you don't believe in that deflationary recession outcome—and we don't—then you should be shifting away from some of those assets.

People always ask, when do I sell high yield? I tell them you sell high yield when you think there's about to be a recession because it's tied to the cash flows of companies. With companies in good shape and default rates low, we see the risk in credit as more tolerable than accepting interest-rate risk in longer-duration assets.

HIGH YIELD: PRICED RIGHT RELATIVE TO LOW RISK PROFILE

High Yield Spreads and Defaults, 1986 to 2013



Sources: JP Morgan, S&P/LCD. Data from December 1986 to March 2013.

What kind of returns should investors expect over the next couple of years?

We find high yield attractive, but with prices at high absolute levels, we expect returns mostly from coupon income—say high single digits. This is still compelling, particularly versus other fixed income alternatives, but different from what we saw over the last few years.

We're starting to see different opportunities in the market. We're seeing differences in how investors want to employ capital, and in the way CEOs and CFOs of companies are thinking of investing themselves. So although high yield and bank loans are not going to produce the same return profile of the past several years, they still offer an attractive relative return in the current market environment, for several reasons: 1) They are shorter-duration spread products, so you're getting income based on the current market spread as opposed to duration (or interest-rate sensitivity); 2) They are tied more to the health of corporations, which have spent the past five years derisking and are in very good shape; and 3) As we start to see more growth in the market (either earnings or economic growth) and more shareholder-friendly activity, that tends to be negative for investment-grade credit and positive for high yield credit because of the covenant protection built into high yield bonds and bank loans.

Now the equity market has the potential to outperform high yield in an environment of dividend growth and operating leverage, but equities will trade with higher volatility. So those looking to anchor their portfolios will find high yield and loans to be good places to have fixed income exposure with less interest rate risk and a more attractive coupon than higher-quality bonds, but with reduced volatility relative to equities.

COMPARABLE RETURNS, SMOOTHER RIDE THAN EQUITIES

Sources: Barclays Capital, Standard & Poor's. Data from December 2010 to March 2013. High yield represented by the Barclays US Corporate High Yield Index and US equities by the S&P 500 Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

How do you navigate an environment of lower expected returns?

As the market continues to turn and yields are in the 6%-8% range, it's going to be less about beta and more about credit selection. In an environment like the last few years, where returns are very high, all managers do well and the higher-beta ones do best. But when return expectations are lower, who you choose to manage your money becomes more important. I think there will still be more winners than losers, but digging deep and doing the research is going to be key. Our platform at BlackRock consists of more than 40 professionals in the leveraged finance business stationed around the world. They do the hard work of selecting the best names for our portfolios based not only on a company's cash flow fundamentals, but also based on an understanding of where in the capital structure you want to be—whether in secured or more toward the equity side of a capital structure.

We are dynamic on moving risk around, whether within a market or within a capital structure. Through our deep and disciplined research process, we strive to understand sector-level and corporate-level cash flow views, as well as legal language in issuer documents so that we really understand the pricing of risk up and down the capital structure. We also devote a lot of resources to managing risk in our portfolios after the trade. We believe it's these things, and the resources we can devote to them, that has set us apart and generated our favorable long-term track record.

With high yield bonds and loans trading at similar yield levels, how do you think about relative value between the two markets?

I like to say I invest in equities with put options, and the value of my put option is based on my expected recovery. High yield bonds are higher in the capital structure than equities, but you're still taking on risk with a long-term recovery rate of 40 cents on the dollar. In most cases, you get paid for that upside potential because you have call protection built in. So if the credit improves, you benefit as the risk premium falls, in which case you get price appreciation in addition to the coupon. Bank loans are highest in a company's capital structure. With most secured loans, the average recovery rate is around 80-85 cents on the dollar. But in order to get that downside protection, you're giving up some upside. Specifically, most bank loans are callable at par immediately, so you run a substantial refinancing risk. Although loan yields today might be high, the markets are pricing in the belief that much of that is going to get refinanced at lower levels over the course of the next year.

All of that said, we like bank loans for their floating rate nature, which helps us to manage duration, and we like that they're secured relative to BB-rated bonds, so they have a quality appeal. For total return potential, we move down the capital structure into high yield bonds as well as convertible securities (bonds convertible into stock) and preferred stock, or occasionally even equity. Ultimately, our job is to look across the scope of leveraged finance and try to find the best risk-adjusted rewards for our investors. We believe there's a place for high yield bonds and bank loans in investor portfolios, and we think most investors today should have exposure to both.

ASSESSING OPPORTUNITY ACROSS THE CAPITAL STRUCTURE

How should investors use high yield in their portfolios?

I think high yield should be a core strategic holding in investors' portfolios. It's an excellent diversifier across fixed income and equity, and over time has given investors about 80% of the return of equities with about half the volatility. More broadly, I would say now is a good time for investors to reduce some of their cash, long-term rates and investment-grade exposure and increase their equity-type risk, including high yield.

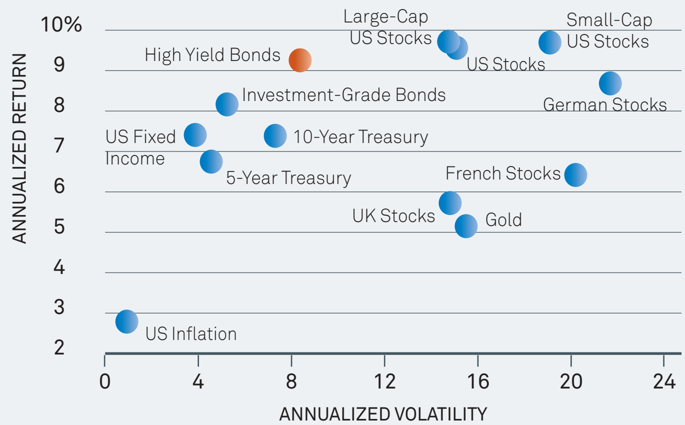
Why put money in high yield right now?

The short and skinny is this: High yield and loan returns may not be as amazing as they were over the past few years, but they are still very attractive on a relative basis in this economy. Two years ago, we could have easily advised investors to maximize their high yield exposure. Today, we're not in that same place, but we still think it makes sense to be at about 70% of your threshold.

On average, we believe the companies in which we invest are in very good shape and well positioned to service their debt in a low-growth environment. They have been proficient at managing expenses and traditional debt measures like debt to cash flow, and cash flow to debt service requirements look very good. Companies have done a lot of refinancing of their debt and, as a result, only about 15% of the high yield market matures over the next three years. Furthermore, most market participants, including us, don't think defaults will run more than 2% a year over the next two years, which means investors are being well paid in high yield today for relatively low credit risk. On a relative basis as well, the current yield to worst of roughly 5.5% and the current coupon yield of over 7%, while low by historical standards, is still by far the most attractive proposition in fixed income markets.

HIGH YIELD APPEARS WELL POSITIONED

Total Return vs. Volatility, 1987-2012



Sources: Barclays Capital, JP Morgan, Bloomberg. High yield bonds represented by the JP Morgan Global High Yield Index; US fixed income by the Barclays Capital Aggregate Bond Index; investment-grade bonds by the JP Morgan JULI High-Grade Index; US stocks by the Wilshire 5000 Total Market Index; large-cap US stocks by the S&P 500 Index; small-cap US stocks by the Russell 2000 Index; UK stocks by the FTSE 100; German stocks by the DAX Index; French stocks by the CAC 40 Index; and US inflation by the US CPI Urban Consumer MoM SA Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Bond values fluctuate in price so the value of your investment can go down depending on market conditions. The two main risks related to fixed income investing are interest-rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. Investments in non-investment-grade debt securities (high-yield or "junk" bonds) may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. Investing in derivatives entails specific risks relating to liquidity, leverage and credit that may reduce returns and/or increase volatility.

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