CION INVESTMENTS

FIVE THINGS TO KNOW ABOUT **NON-INVESTMENT GRADE** ASSETS

In a low-yield environment, investors typically look for below-investment grade assets as a source of increased yield. We take a closer look and breakdown five things you should know before you invest.

WHAT IS NON-INVESTMENT GRADE?

Non-investment grade securities are those with a rating below Baa3 or BBB-[1].The best-known type is high yield, which are the securities of a publicly-traded company or municipality that has experienced a ratings downgrade or other negative event (so-called "distressed"). High yield can also be debt that is originally issued below investment grade. Since the 1980s, high yield bonds have become more widely deployed in investor portfolios as a source of additional yield over investment-grade bonds.

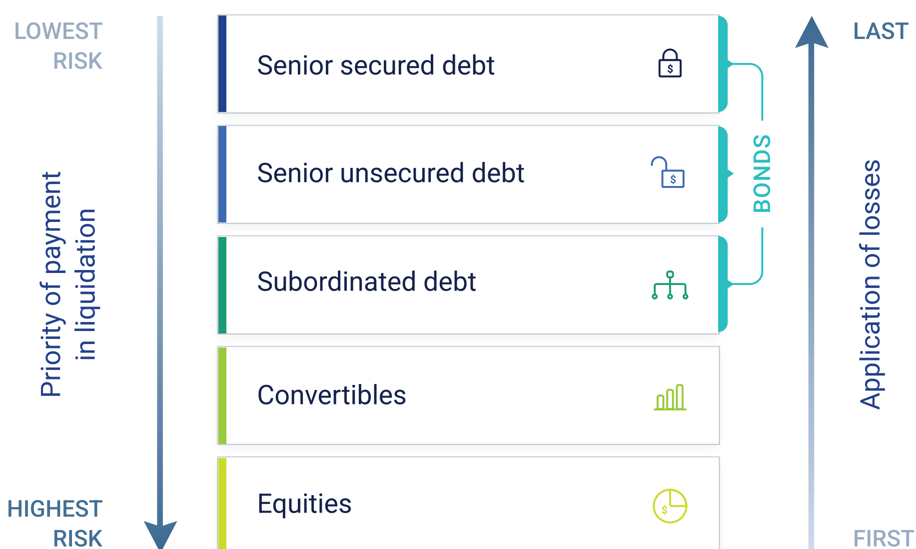
However, a new type of non-investment grade asset has gained traction – private debt. These are loans made directly to companies that are not traded on public exchanges. These loans typically offer higher yields, which result from the scarcity of funding for these companies and the illiquidity premium these loans convey. They require a great deal of fundamental research and due diligence from the lender, not just because of extra risk but also due to the complicated nature of the loan construction.

WHAT'S THE REWARD/RISK PROFILE?

As discussed on the previous page, both high yield and private debt offer more yield than other types of assets. In addition private debt, through direct origination, can incorporate risk mitigating elements. Because lenders are a source of non-bank funding for companies that may not have access to capital otherwise, they are able to invest at the top of the company's capital stack.

This means that the loans – called senior secured debt – are backed up by the company's assets and that the lender has priority recourse. This combination of increased yield and risk mitigation may provide for an improved return/risk profile.

The Capital Stack



WHAT ABOUT INTEREST RATE RISK?

High yield securities typically have shorter maturities and so are less sensitive to interest rate movements. Senior secured loans are typically floating rate, which means investors can mitigate interest rate risk in their portfolios.

CAN WE REVIEW THE LIQUIDITY/ ILLIQUIDITY THING AGAIN?

High yield bonds generally trade on exchanges or in the secondary market. However, it is also common for a high yield bond manager to hold the bonds until maturity. With private debt, the lender originates the loan, holds it through its life (usually 5-7 years), receives the interest payments and then gets the remaining principal at the end. Private debt is illiquid – but in exchange for the lack of liquidity, private debt carries an illiquidity premium, relative to liquid assets.

BESIDES A SOURCE OF YIELD, HOW DO THEY FIT IN AN INVESTOR PORTFOLIO?

We've covered return, risk mitigation, and illiquidity premium – but there is an additional source of portfolio utility. In addition to offering enhanced yields, sub-investment grade bonds as an asset class can add meaningful diversification as well. High yield bonds generally feature lower correlation to investment grade corporate and treasury bonds (0.32 and -0.1, respectively[2]) which can potentially smooth out a portfolio's market value in volatile bond market conditions. While diversification cannot reduce risk of losses to zero, including less correlated securities alongside traditional fixed income assets can help decrease overall portfolio risk.

Private debt is negatively correlated to global bonds, and has only moderate correlation to equities, which can also help to diversify a portfolio. In addition, private debt tends to focus on middle-market companies (those between $10 million and $1 billion market cap) – and there are almost 180,000 of them, across geographies and sectors, so there is potential to invest in companies that can provide cyclical defensiveness.

Non-investment grade assets can be a useful addition to investor portfolios, providing both yield pick-up and a source of diversification. Even though they may not be rated investment grade, as long as they hold a place high in a company's capital stack they can be a worthwhile asset to consider.

RISKS

The potential benefits of high yield bonds do not come without increased exposure to a few kinds of investment risks. In comparison to investment grade corporate and government bonds, high yield bonds have a higher risk of default and are generally more volatile in terms of their current market value. Over longer investment horizons high yield bonds exhibit premium returns, especially if purchased at a discount to par value. In the short-term however, high yield bonds are subject to swings in value and heightened defaults when economic conditions become less favorable. Because of their risk-return profile, it is imperative that investors are diversifying properly across issuers and market segments. A typical way for investors to access high yield bonds with a degree of diversification is through investment funds that make use of them rather than investing in single bonds.

As with any asset class, there are certain risks associated with private credit. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because private credit can be debt investments in non-investment grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, private credit investments are generally illiquid which require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.

To learn more about non-investment grade assets, please contact your financial professional.

Footnotes

1. Sub-investment grade/high yield bonds are bonds with a credit rating below investment grade (Baa3 or BBB-), as judged by the bond ratings assigned by one of the major rating agencies: Moody's Investors Service (Moody's) and Standard & Poor's. The ratings are the opinion of the agency. They are not a guarantee of credit quality, probability of default, or recommendation to buy or sell.
2. Represented by 10 year correlation between Bloomberg Barclays US Corporate High Yield Total Return Index, Bloomberg Barclays US Corporate Total Return Index, and Bloomberg Barclays US Treasury Total Return Index as of 08/31/2022.

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