Aggressive-income Investing: More Than Just High Yield

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What You Need to Know

- We recommend adding aggressive-income investments only if you already own income investments. You may have aggressive-income exposure through an investment-grade bond fund. Therefore, a dedicated high-yield fund may not be necessary.
- Aggressive-income investments can help boost your portfolio's overall risk-adjusted return.
- Aggressive-income investments carry a higher degree of risk, so it's important to diversify.
- We believe the best way to invest in aggressive income is through diversified and professionally managed mutual funds.
- Aggressve-income investments involve certain types of risk, including credit, international and structural risk.
- Depending on your circumstances, we recommend allocating up to 15% of your portfolio to aggressive income.

If you want more income from your investments, you may need to become more aggressive – within limits.

Aggressive-income investments typically pay higher interest rates – and more income – than income investments. And while aggressive-income vehicles also carry a higher degree of risk, if owned in the right amounts they can help boost your portfolio's overall risk-adjusted return. We recommend an allocation of up to 15% of your portfolio to aggressive income – depending on your circumstances – while remaining diversified within this allocation.

Aggressive-income investments can include bonds rated below investment-grade quality, high-yield bond funds, bank loan funds, multisector bond funds, leveraged closed-end funds, trust-preferred securities and certain preferred stocks and collateralized mortgage obligations (CMOs), as well as exchange-traded funds (ETFs) based on these investments. However, not every kind of aggressive-income investment is suitable for individual investor portfolios. In some cases, the risks outweigh the benefits. We believe the best way to invest in aggressive income is through diversified and professionally managed mutual funds.

Total Portfolio Focus

Building a properly allocated and broadly diversified portfolio can help you reach your financial goals. Although you can achieve adequate diversification without including aggressive-income investments, we believe that, if purchased through a professionally managed mutual fund in appropriate amounts, these investments can help improve your portfolio's long-term risk-adjusted returns.

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Benefits of Aggressive-income Investments

As the following table suggests, adding aggressive-income investments can help improve the total return of a portfolio. These investments are typically more sensitive to credit and/or currency risk, unlike income investments of investment-grade quality, which are more sensitive to interest rate changes. So, in the long run, you may be able to lift the risk-adjusted return of your portfolio by adding appropriate amounts of aggressive income. In the short run, however, be prepared for the potential of significantly greater price volatility, as illustrated by the standard deviation measurement below.

Fixed-income Category	Annualized 10-year Total Return	10-year Standard Deviation
U.S. Investment-grade Taxable Bonds[1]	3.48%	2.84%
Investment-grade Municipal Bonds[2]	4.24%	3.45%
High-yield Bonds[3]	9.25%	6.75%
Multi-sector Bonds[4]	6.19%	4.26%
High-yield Municipal Bonds[5]	7.79%	5.78%

Source: Bloomberg Barclays Indices, Morningstar (2009-2018).

Standard deviation is a measure of risk-quantifying investment-price variance. Higher standard deviation indicates more volatility. Past performance is not a guarantee of future results.

1 U.S. Investment-grade Taxable Bonds = Bloomberg Barclays U.S. Aggregate Bond Index

2 Investment-grade Municipal Bonds represent an average of all funds in the Morningstar Municipal National Intermediate Bond category.

3 High-yield Bonds represent an average of all funds in the Morningstar High-yield Bond category.

4 Multi-sector Bonds represent an average of all funds in Morningstar Multi-sector Bond category.

5 High-yield Municipal Bonds represent an average of all funds in the Morningstar High-yield Municipal Bond category.

The following table shows how a portfolio that included 10% in high-yield bonds provided better returns than an all-investment-grade U.S. bond portfolio over the past 10 years, while actually reducing risk. As a result, including aggressive-income investments enhanced the risk-adjusted return of the portfolio.

Aggressive Income Can Help Increase Risk-adjusted Returns
10 Years (2009-2018)

Fixed Income Included in Portfolio	Return	Standard Deviation
90% U.S. Investment-grade/10% High-yield Bonds	4.25%	2.77%
100% U.S. Investment-grade Bonds	3.48%	2.84%

Source: Morningstar. U.S. Investment-grade = Bloomberg Barclays U.S. Aggregate Bonds Index. High-yield = Bloomberg Barclays U.S. Corporate High-yield 2% Issuer Capped Index. Past performance doesn't guarantee future results.

Risk-adjusted Return: Investing is a balance of risk and return. This measure redefines an investment's return by factoring in how much risk was taken to achieve the return. It's fairly easy to calculate an investment's specific return, but we believe it's also important to consider how much risk was taken to achieve that return.

Risks of Aggressive-income Investments

Credit Risk

In many cases, the higher risk of aggressive-income investments is tied to greater credit risk. Companies and institutions in a weaker financial condition typically have lower credit ratings on their debt. These aggressive-income investments are often referred to as high-yield or "junk" investments. Independent credit rating agencies such as Standard & Poor's (S&P), Moody's and Fitch assign credit ratings based on the likelihood that a bond issuer could default on debt obligations by failing to make timely interest or principal payments. The greater the likelihood of default, the higher the interest rate the issuer must pay to investors.

Emerging-markets Risk

Countries such as China, South Korea, Taiwan and India have lower per capita income and generally younger, less mature economies compared to more developed countries. In addition, their capital markets may be less developed and less regulated. Emerging markets have greater risk of political instability and other risks relative to developed markets. Emerging market bond funds and international/global bond funds that typically invest a substantial portion of their portfolios in the debt of emerging markets have unique risks and are classified as aggressive-income investments.

Structural Risk

Investments with certain structural issues also can be considered aggressive income. These issues can include certain investment features as well as using leverage (borrowing) or derivatives to enhance yield. We believe these structural flaws usually make inappropriate investments and we recommend avoiding them.

Preferred Stocks

These stocks typically have "perpetual terms," meaning there is no maturity date by which principal must be returned to investors.

Trust-preferred Securities

May have some characteristics of preferred stocks and bonds. They are structured so the issuer can defer interest payments for several years without filing for bankruptcy. However, the investors still owe income taxes on the accrued, though as-yet-unpaid, interest payments.

Closed-end Funds

Many closed-end funds rely on leverage – the use of borrowed funds to purchase more of an investment to increase the potential gain. At the same time, leverage can increase price volatility and the potential loss of an investment. That is why excessive leverage is considered an aggressive strategy.

Structured Products

These investments – like collateralized debt obligations (CDOs), collateralized loan obligations (CLOs) and certain tranches, or portions, of CMOs (related securities offered as part of the same transaction) – may be structured in ways that justify an aggressive-income label. Some bond funds also make excessive use of derivative instruments.

Strategies for Owning Aggressive-income Investments

Aggressive-income investments are not suitable for all investors. While these investments offer the potential for higher rates, the trade-off is greater volatility, even when they enhance risk-adjusted portfolio returns. In the end, whether you choose to own aggressive-income investments depends on your income needs and risk preferences. But if you decide to add these investments to your portfolio, consider the following suggestions.

Limit your exposure.

Because aggressive-income investments can be volatile, first make sure you are comfortable owning them. Then work with your financial advisor to determine the right types and amounts to allocate to aggressive income, based on your comfort with risk and your financial goals. We recommend you hold no more than 15% of your overall portfolio in aggressive-income investments.

Own aggressive-income investments through mutual funds.

Aggressive-income investments are complex and subject to greater potential price swings. If you choose to own them, we recommend you do so through diversified and professionally managed mutual funds. The greater complexity of these investments is due to a higher degree of credit risk, emerging-market risk, structural risk or some combination of these. Mutual fund managers have the resources to better analyze, and help manage, the risks of aggressive-income investments. Nevertheless, we don't believe that aggressive-income investments with excessive structural risk are appropriate, even within a mutual fund.

Avoid certain types of aggressive-income investments.

There are also aggressive-income investments to avoid. We don't recommend you purchase aggressive-income investments we consider to have excessive credit or structural risks that outweigh the potential benefits. These investments include individual below-investment-grade quality bonds, high-yield preferred stocks, trust-preferred securities, leveraged closed-end funds, CDOs, CLOs and aggressive-income CMOs.

