CIFC Asset Management

CIFC Portfolio Intelligence

Value of High Yield

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Featured Views and Insights

As we approach the end of 2024 and begin to focus on 2025, we believe the opportunity set in high yield remains robust despite relatively muted high-level market metrics. Our note offers an overview of current market composition and highlights the opportunity to extract value through differing ways of measuring spread/yield as well as identifying dispersion.

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Mr. Horowitz brings 29 years of alternative investment experience to CIFC. Previously, he worked at Millennium Management, where he served as Portfolio Manager for a long/short corporate credit strategy with an emphasis on U.S. High Yield. Before that, Mr. Horowitz spent 13 years at Muzinich & Co., most recently as the lead Portfolio Manager overseeing a long/short corporate credit hedge fund. Prior to that, he served as an equity and high yield research analyst at Credit Suisse. Mr. Horowitz earned a B.A. in Sociology from Yeshiva University and an M.B.A. in Finance from the Yale School of Management.

Current Market Composition

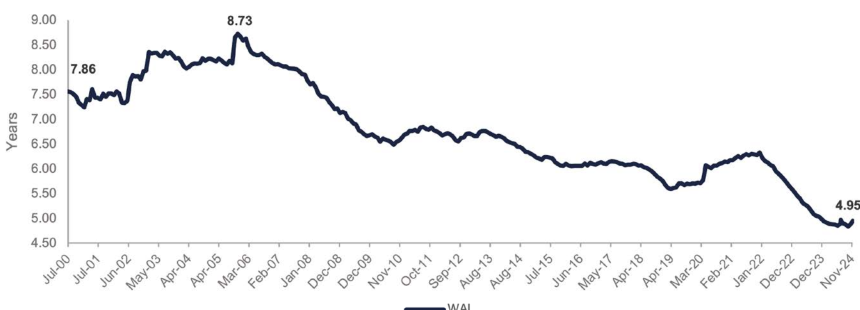
The composition of the bond market has evolved, with increased security, shorter maturities, better ratings and a high rate of bonds being redeemed well before maturity given active liquidity management by issuers. While index-level volatility may remain low, dispersion between individual bonds persists and is a market technical that creates opportunities.

We believe the credit quality for U.S. high yield has improved due to the percentage of the market that is secured sitting at its highest level in history. After the outbreak of COVID, many companies were forced to issue secured bonds to build cash or refinance near-term maturities. Post COVID, companies continued to offer asset security to obtain lower coupons. Additionally, the percentage of secured bonds increased because many bank loans were refinanced with secured bonds. As of November 2024, 35% of the U.S. high yield market is now secured – versus only 8% in 2000.[1]

HY Index (FTSE) Secured %[1]

In terms of maturities, one can see below that the average is now at its lowest level on record. As of November 15, 2024, the weighted average life of a U.S. high yield bond is 4.95 years – down from 8.73 years in October 2005.[1] A lower maturity reduces duration risk to the portfolio and increases the value of the pull to par. For example, a three-year bond at $97 will pull to par twice as quickly as a six-year bond priced at $97.

HY Index (FTSE) Weighted Average Life (WAL)[1]

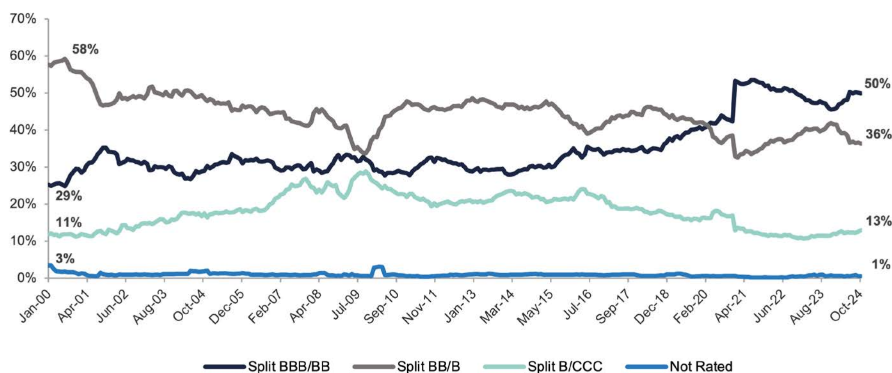


The average maturity of U.S. high yield bonds has declined precipitously for several reasons, mainly the tenor of new issuance. During the COVID pandemic, companies had to offer outsized coupons and thus wanted to keep maturities as short as possible to minimize the pain of higher interest expense. Also, we observe that investors have recently preferred to limit duration risk in their portfolios and have been willing to take lower coupons for five-year bonds versus longer ones.

New Issue Average Years to Maturity[2]

As indicated by the graph below, aside from during COVID, when many companies were downgraded to high yield from investment grade, the U.S. high yield market has never been as highly rated as it is today. BBs now represent 50% of the market – up from only 29% in 2000 – while CCCs are near the lowest level of the past 25 years.[3]

U.S. High Yield Market Ratings Changes Over Time[3]



Rate sensitivity and duration are two additional components we considered when looking at the current market composition. The table on the next page highlights the starting point for the expected one-year total return for U.S. high yield bonds based on changes in the U.S. five-year treasury and when the average bond is redeemed. Investors can then assign default and recovery rates based on their expectations of the economy and financing conditions. Currently, the market is pricing U.S. high yield at 7.2% (average maturity of 4.8 years), but we believe the more realistic average maturity is 3.3 years. If the market environment were to price bonds at 7.2% to this expected redemption, bonds would

have to trade higher, generating a one-year total return of 8.8% (shown below). Additionally, the 8.8% return would jump to a 11.0% return if rates tighten by 75 bps, based on our analysis in the chart below. If the five-year widens by 75 bps, the return would still be a respectable 6.0% if bonds are redeemed 1.5 years early.[4]

U.S. HY Index 1yr Return (assume 7.2% YTW at end of 1yr)[4]

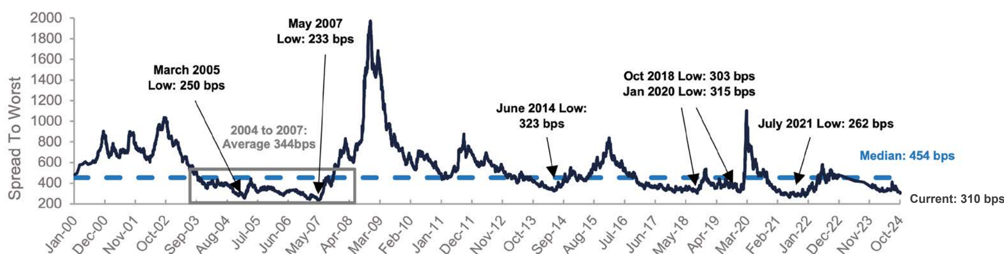
Years to Redemption	Change in 5yr treasury (bps)						
	-75	-50	-25	0	25	50	75
2.3	12.0%	11.3%	10.5%	9.8%	8.9%	7.9%	7.0%
2.8	11.5%	10.8%	10.0%	9.3%	8.4%	7.4%	6.5%
3.3	11.0%	10.3%	9.5%	8.8%	7.9%	7.0%	6.0%
3.8	10.5%	9.8%	9.1%	8.3%	7.4%	6.5%	5.5%
4.3	10.1%	9.3%	8.6%	7.9%	7.0%	6.0%	5.0%
4.8	9.6%	8.9%	8.2%	7.2%	6.5%	5.6%	4.6%

Different Ways to Measure Spread Levels

As a starting point, we offer insight into an alternative view around the analysis of spread levels and incorporation into idea generation. Conventional wisdom suggests spread to worst (STW) is a starting point, and, while appropriate, the pace at which bonds are currently being taken out prior to maturity suggests an opportunity exists to benefit from this trend. As outlined, yield to expected (YTE) is a metric we have been incorporating into our process which takes into account the current market composition as evidenced by the significant reduction in WAL of the HY Index.

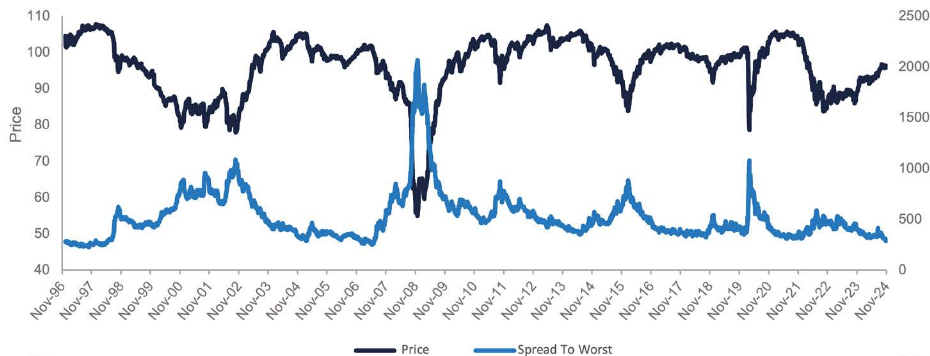
Most conversations on valuation for the U.S. high yield market start by examining the STW relative to historical periods. In the absence of a restructuring, we believe the STW is the most conservative way to measure an investor's expected return over treasuries. The graph below highlights that the spread to worst is still about 70 bps off its lows but well below its historical average.[5]

U.S. High Yield Historical Spread to Worst[5]



However, while the STW is usually an appropriate and reasonable metric, we believe it is misleading in this unique environment. As we highlighted in our November 2023 Portfolio Intelligence note, prior to the Fed's latest hiking cycle in early 2022, we had not seen a time in our careers when the average dollar price of high yield bonds was firmly below par in a non-stressed environment.

Average Index Bond Price and Spread[6]



Said another way, in our view, many bonds are below par because treasury rates jumped after the bonds were issued – not because investors are increasingly concerned about defaults. Importantly, despite the favorable coupons to the issuers, our view remains that most bonds will be redeemed well before maturity. As opposed to investment grade, we believe most high yield management teams recognize the risk of the financing market closing or becoming significantly more challenging. Companies often call their bonds before maturity to prevent a liquidity crisis or the need to offer painful concessions. This is one reason the vast majority of high yield bonds are issued with early call options for the company. In fact, over the past 20 years, only ~11% of U.S. high yield bonds have ultimately matured.[7,8]

Spread to Expected Redemption

Because most bonds do not mature, we consider the spread to expected redemption over the spread to worst – the latter of which assumes all bonds trading below par (66% of the market) go to maturity.[7,8] The earlier redemption means that discounted bonds will accrete to par at a faster rate than calculated by the spread to worst.

Our top-down analysis assumes the average bond is redeemed 1.5-2.0 years before maturity, generating a spread to expected redemption between 40 bps and 60 bps above the reported spread to worst. Historically, bond redemptions (which excludes maturities) have occurred 3.5 years before maturity, but we are using a shorter time horizon to be conservative and to reflect the current makeup of the market (shorter maturities and less of a benefit to early redemptions).[3,4] Our confidence is bolstered by

our tracking of redemptions since the end of September 2023. Since that time, called bonds have been redeemed an average of 2.1 years before maturity. This excludes nine announced M&A deals that would add another $10 billion of bonds likely to come out an estimated 2.8 years before maturity.[9]

Yield to Expected[10]

HY Index Yield to Expected

Years to Maturity	Yield to Expected
2.3	8.3%
2.8	7.9%
3.3	7.7%
3.8	7.5%
4.3	7.4%
4.8	7.2%

HY Bonds Redeemed Prior to Maturity

Month	Total	Avg Yrs to Maturity
October 2023	6,362	2.2
November 2023	6,374	1.9
December 2023	7,262	1.1
January 2024	18,304	2.1
February 2024	19,593	1.8
March 2024	16,778	2.9
April 2024	15,716	2.3
May 2024	20,538	2.0
June 2024	9,701	2.4
July 2024	10,009	1.9
August 2024	9,589	2.0
September 2024	13,489	1.8
October 2024	5,969	2.0
Total/Weighted Average	**159,684**	**2.1**

To provide an example of how the early redemption enhances the value of the high yield market, we reference the Building Materials Corp notes maturing in February 2027 but callable at par as of 2/15/25.[11] The spread to worst is only 157 bps, as it is assumed the market is not concerned about a default (we estimate the loan to value at ~50%, normalized free cash flow to debt of 10% and liquidity of $2.1 billion). If the bond is redeemed 18 months early, the STW nearly doubles – to 319 bps from 157 bps today – as the accretion to par would accelerate to nine months instead of 27 months to maturity.[10] While the company may have to issue new notes at a higher coupon, in our view, calling the bond early avoids market and interest rate risk for the company's owners.

Example[10,11]

Bond	Coupon	Maturity	Price	YTW	YTM	12 months early	18 months early
BMCAUS 5% '27	5.00%	2/15/2027	98.25	5.84%	5.84%	6.48%	7.46%
				STW	**STM**	**12 months early**	**18 months early**
BMCAUS 5% '27				157 bps	157 bps	221 bps	319 bps

Relative Spread Levels

Another factor we consider when comparing spreads to a historical average is the macroeconomic environment. For example, we believe it is reasonable for spreads to be tighter in a period when the Fed is likely cutting rates relative to a time when the Fed was aggressively raising rates, as it was in 2Q22. In addition, we think it is important to consider the composition of the market being evaluated. We believe, all else being equal, a higher rated market with more security, a shorter duration and low expected defaults should trade at a tighter spread.

According to Barclays, relative to 2007, when spreads were at all-time tights, the difference in credit quality and maturity should adjust the market spread by ~51 bps. As a result, it estimates spreads are roughly 100 bps wider today than in 2007, on an adjusted basis.[12]

Dispersion in the Market

Finally, dispersion comes in many forms, including duration, ratings, price points, cyclicality of the business model or sector. Often, dispersion results from an event, such as commodities in 2015-2016, the reopening theme following COVID or companies susceptible to tariffs in 2019 – and likely 2025. We view U.S. high yield as a collection of ~1,850 bonds as opposed to one market We believe managers who understand the technicals and liquidity of the market can often take advantage of this dispersion. We currently segment the market based on eight factors, though the factors

will change based on our macro and market outlook. The shaded boxes below denote meaningful price dispersion for the respective time period (all returns below are price only). For example, the Beta Cable and Telecom bucket (boxed) is up 5.3% year to date, versus 2.5% for the index, but is up 8.1% over the past month alone (as of 9/30/24), as the sector recently benefited from industry M&A and sentiment around AI. Those who avoided this group, which was down 11.33% in the first four months of the year, have likely lagged the market more recently.

Current Market Segmentation[13,14,15]

Bucket	% of index (J0A0)	YTW	DTW	Today	Yesterday	5 Day	1 Month	2024 Price Return
Factors								
Energy	12.2%	6.69%	3.16	-0.09	-0.01	-0.44	-0.52	1.42
Distressed	3.0%	25.15%	2.64	0.13	0.21	0.01	4.98	2.20
Short Duration Non-Recessionary	6.5%	5.95%	1.20	0.03	0.04	0.11	0.69	1.81
Short Duration Recessionary	4.6%	6.15%	1.12	0.00	0.02	0.01	0.31	1.49
Recessionary (Regular Duration)	27.2%	6.56%	3.69	-0.02	0.11	0.08	0.95	2.24
CCC (Remaining)	4.8%	7.95%	3.53	-0.06	0.16	0.09	1.71	7.85
Beta Cable & Telecom	3.9%	13.73%	3.48	-0.23	1.83	1.32	8.07	5.34
High Quality Long Duration	9.0%	5.50%	4.94	0.00	0.09	-0.02	0.84	2.71
Total Index	100%	6.95%	3.28	-0.02	0.14	0.01	1.08	2.53

Data as of September 30, 2024.
Note: Returns reflect price moves only.

Conclusion

In summary, we believe the U.S. high yield market is an attractive asset class, owing to improved credit quality, shorter duration, accelerated pull to par and ability to capture dispersion. We would also highlight that the domestic economy appears to be healthy, defaults are expected to remain low and credit demand should benefit from an aging population.

In addition, in our view, it is important for investors to allocate capital to managers able to identify themes, capture dispersion and understand how to utilize the liquidity of the market to their benefit. The CIFC investment team leverages its many years of market experience to uncover the most meaningful risks, opportunities and themes for the high yield market. It runs many screens and combines its fundamental and technical skills to capture bonds influenced by its macro and thematic views. To determine these market themes, the high yield team triangulates between its macro outlook, commentary from its relationships and computed data.

1. Source: Citi. Data as of November 15, 2024.
2. Source: Barclays Research. Data as of October 31, 2024.
3. Source: J.P. Morgan Research. Data as of October 31, 2024. Data included for illustrative and discussion purposes only.
4. Source: CIFC. Data as of October 31, 2024. Figures shown are based on CIFC's current data and assumptions; subject to change without notice. Past performance does not guarantee future results. Actual returns will vary depending on the applicable fees and expenses. No guarantee similar assets will be available for investment in the future.
5. Source: ICE BofA U.S. Cash Pay High Yield Index (J0A0). Data as of October 31, 2024.
6. Source: Bloomberg. Data as of November 18, 2024.
7. Source: J.P. Morgan Research. Data as of October 31, 2024. Data included for illustrative and discussion purposes only.
8. Source: Citi. Data as of November 15, 2024.
9. Source: CIFC. Data as of October 31, 2024. Figures shown are based on CIFC's current data and assumptions; subject to change without notice. Past performance does not guarantee future results. Actual returns will vary depending on the applicable fees and expenses. No guarantee similar assets will be available for investment in the future.
10. Source: CIFC. Data as of October 31, 2024. Figures shown are based on CIFC's current data and assumptions; subject to change without notice. Past performance does not guarantee future results. Actual returns will vary depending on the applicable fees and expenses. No guarantee similar assets will be available for investment in the future.
11. Source: Bloomberg. Data as of November 15, 2024.
12. Source: Barclays Research. Data as of October 31, 2024.
13. Source: Table data source is Bloomberg. Data as of September 30, 2024. This is included as an illustrative example. Buckets are derived from the J0A0 and based on internal screens. The buckets shown are not intended to represent the actual size of the subsegments of the market or investment targets. The CIFC investment team tracks different subsegments based on market environment and outlook. Each bond is only assigned one category. Cells are highlighted for discussion purposes.
14. Table returns based on ICE Bank of America High Yield Index and Bloomberg.
15. Index number on table does not account for bonds entering and leaving the index mid-month.

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Index Definitions:

The BofA Merrill Lynch US Cash Pay High Yield Index (J0A0): The BofA Merrill Lynch US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly issued in the US domestic market.

The ICE BofA US Cash Pay High Yield Energy Index (J0EN): tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly issued in the US domestic market (Energy Sector).

The BofA Merrill Lynch BB US Cash Pay High Yield Constrained Index (JUC1): The BofA Merrill Lynch BB US Cash Pay High Yield Constrained Index contains all securities in The BofA Merrill Lynch US Cash Pay High Yield Index that are rated BB1 through BB3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 2%.

Bloomberg FINRA TRACE Market Breadth High Yield Bond Dollar Volume (NTMBHV): The Market Aggregate statistics provides an end-of-day recap of the bond market activity in publicly traded TRACE eligible securities.

FINRA TRACE 144a High Yield $ Volumes (NTMB4HYV): FINRA's 144A Dissemination ServiceSM (144ASM) broadcasts last sale price and other relevant trade data for U.S. dollar-denominated private placement, investment grade and high yield corporate bonds to authorized market data vendors.

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