The High Yield Market in Perspective

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A Fund Liquidation and Aftermath

News of the pending liquidation of a high yield distressed credit bond fund has raised concerns broadly among high yield investors that there may be more fund liquidations to come. Such funds represent a small segment of the high yield asset class; in our view, there will be limited overlap between the announced liquidation and most other high yield (HY) portfolios, Voya's included. Distressed debt funds invest in securities of companies or government entities that are experiencing financial distress, and carry significant risk that bankruptcy may render their holdings worthless. The fund in question held concentrated positions in illiquid securities, but had an open-ended fund structure that obliged it to offer daily liquidity to its investors. Faced with a need to meet significant redemption requests, the fund resorted to selling its relatively more liquid holdings. That left the remaining portfolio even more concentrated and less liquid; this triggered a vicious cycle of worsening performance and accelerating redemptions, until the fund was forced to liquidate.

Though this is a special case, it raises general concerns about the high yield market. The negative headlines could prompt investors to withdraw money from other high yield investment vehicles, creating a one-sided market where sellers outnumber buyers and pushing down prices. In our view, this price pressure is likely to first affect exchange-traded funds ("ETFs"), which we see as the vehicles of choice for shorter-term investors. This pressure was apparent last Friday, December 11, 2015, as both the iShares iBoxx $ High Yield Corporate Bond ETF (HYG) and the SPDR® Barclays High Yield Bond ETF (JNK) declined more than 2%, according to Bloomberg data.

This also shows in the high yield trades reported last Friday in the FINRA Trade Reporting and Compliance Engine, which showed a change in the mix of bonds that have sustained significant price declines. Before last week price declines had been largely limited to energy/commodities bonds or those that had negative earnings or other news. By contrast, on December 11 the selling was concentrated in more liquid bonds, implying to us that (a) investors were selling what they could, and (b) the ETFs likely represented the lion's share of the selling.

What's Happening Now in the High Yield Market?

Cause of Move. For most of this year, the selling in high yield was largely confined to the energy sector and the metals and mining sector, reflecting concerns about global growth and falling commodity prices. In recent weeks the selling broadened to include other sectors, largely the result of sector-specific headlines, e.g., in pharmaceuticals, or company-specific news such as earnings misses. At the end of last week we saw a more broad-based move driven by negative headlines and resulting flows out of high yield.

Extent of Move. As selling accelerated on December 11, prices moved sharply lower, as measured by Barclays indexes. The broad Barclays High Yield Bond 2% Issuer Constrained Composite Index lost 1.08% for the day; the Barclays U.S. High Yield Very Liquid Index, which is more directly impacted by ETF selling, lost 1.37%. This brought losses over the last three months to 5.20% on the broad index. Over that period of time, energy lost 13.4% and metals and mining lost 14.5%, implying that the remainder of the market lost approximately 2.5%.

Based on Friday's index pricing, Barclays put the index yield at 8.71% — an option-adjusted spread (OAS) of 672 basis points — the highest yield since late 2011. (A basis point equals one one-hundredth of one percent.) According to Voya's estimates, excluding the energy and metals and mining sectors the yield was approximately 8% and the OAS approximately 700 basis points.

What Happens Next?

U.S. economic data have been marginally on the weak side, but our base case view remains that the recovery will continue — even if at a less than robust pace.

Credit fundamentals continue to weaken as top-line growth and profit growth remain challenging, even outside commodity-related sectors. Interest coverage and liquidity remain good, however, and we believe most companies are in a position to ride out periods of sluggishness. Further, we have not seen the aggressive re-leveraging of past cycles, which should limit the negative impact of a more pronounced downturn in the credit cycle.

The outcome of the Federal Reserve meeting this week is almost certainly weighing on the market at present. A single rate hike really shouldn't be enough to spook investors — it has been well-telegraphed and will almost certainly be accompanied by reassurances of a protracted cycle of small, incremental increases. But it does potentially represent the beginning of the end of the ultra-easy money cycle and comes at a time when economic growth remains sluggish.

What are the Opportunities in High Yield?

At least from a mathematical perspective, we have the prospect of better returns than the sell-side strategists published in their 2016 outlooks just a few weeks ago. The consensus of those forecasts was for low, single-digit returns. It would not take many more negative days to raise the prospect of high, single-digit returns, which in our view would stack up well against most other asset classes.

The market remains bifurcated, with commodities-linked bonds and lower quality bonds trading much wider than the non-commodity sectors of the market. Excluding energy and metals and mining, BB-rated bonds currently trade in the mid-5% range and B-rated bonds trade in the high 7% range, according to Voya estimates. With oversupply and weakening global demand in virtually every commodity, we believe there is more shake-out to come in the distressed part of the market.

We view spreads as reasonably attractive for the risk in the non-distressed part of the market, though it is difficult to argue the high yield market is wildly cheap there. At this point we believe opportunities are more issuer-specific, as we have seen the occasional "baby" thrown out with the bath water. In our view, such opportunities make a case for active management based on strong fundamental credit analysis.

Using a standard 40% recovery rate assumption, we estimate the market to be pricing in a 5.8% default rate outside energy and a 15.7% default rate within energy. Put another way, market pricing suggests a 5.4% loss-adjusted yield for energy and a 4.8% loss-adjusted yield ex-energy. We believe the default rate within the energy sector may be higher and recoveries lower, but we expect the ex-energy default rate to be only about 3%. We find that adjusting the recovery rate in the energy sector to 20% reduces the loss-adjusted yield to 2.2%. Using a 3% default rate for ex-energy, we get a loss-adjusted yield of 6.5%.

These results support our view that the energy sector is not yet cheap enough to compensate for anticipated credit losses, whereas the rest of the market is getting to levels that look reasonably attractive. These findings are in keeping with our positioning, which is underweight energy in favor of non-energy sectors.

Voya High Yield Performance as of November 30, 2015

Randy Parrish, CFA, leads Voya IM's dedicated high yield team while also leveraging the broader resources of the Voya Investment Management fixed income platform. As of September 30, 2015, the team managed $3.7 billion[1]; its information ratio ranked in the 1st percentile for the 5 year period ending September 30, 2015 according to eVestment Alliance.[1]

As of November 30, 2015, Voya's high yield strategy continues to deliver competitive results relative to its benchmark.

Voya High Yield Composite

As of 11/30/15	Gross Return	Net Return	Benchmark Return	Gross Spread
YTD	0.92%	0.46%	-1.97%	2.88%
1 Year	-0.76%	-1.26%	-3.38%	2.62%
3 Year	4.64%	4.12%	3.11%	1.53%
5 Year	7.46%	6.95%	5.95%	1.51%
10 Year	7.16%	6.66%	7.32%	-0.16%
Inception	7.08%	6.52%	6.71%	0.37%

Benchmark = Barclays High Yield Bond 2% Issuer Constrained Composite Index

Notes: Periods greater than one year are annualized. Performance data is considered final unless indicated as preliminary. Monthly performance is based on full GIPS Composite returns. The full GIPS Composite is available upon request.

The Composite represents the investment results of a group of fully discretionary portfolios managed according to the strategy. Returns include the reinvestment of income. Gross returns are presented after transaction costs, but before management fees, which in addition to other fees incurred in the management of the portfolio, would further reduce returns. For a description of advisory fees, please see Form ADV, Part II. **Past performance is no guarantee of future results and the possibility of loss does exist.** Benchmark source: Barclays.

[1] Source: eVestment Alliance and Voya Investment Management

Excess returns and competitive rankings presented are based on "composites", calculated as an asset-weighted average return of similarly-managed individual portfolios. Returns are presented before the deduction of management fees and will be reduced by advisory fees and other fees incurred in the management of the portfolio. Excess Return is calculated as the difference between the performance returns of the investment strategy composite and the respective benchmark return over the measurement period presented, and is annualized for periods greater than 1 year. The color-coded columns of data above are highlighted according to the key provided and indicate the quartile ranking within relevant eVestment Alliance manager categories using gross-of-fees returns. **To learn more on the GIPS® compliance Schedule of Composite Performance go to: http://www.voyainvestments.com/US/ProductsandServices/Institutional/index.htm.**

Investment Risks

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. **High-yield securities**, or "junk bonds," are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. The Fund may use **derivatives**, such as options and futures, which can be illiquid, may disproportionately increase losses and have a potentially large impact on Fund performance. **Foreign investing** poses special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. Risks of foreign investing are generally intensified in **emerging markets**. As **interest rates** rise, bond prices may fall, reducing the value of the Fund's share price. Debt securities with longer durations tend to be more sensitive to interest rate changes. Other risks of the Fund include but are not limited to: **credit risks; other investment companies' risks; price volatility risks; inability to sell securities risks; and securities lending risks**.

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