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Junk bonds start to live up to their name

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So maybe junk bonds don't have anything to do with actual junk, but they are related to low interest rates.

by Amy Scott (/people/amy-scott)
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Junk. High-yield. Non-investment grade. They're all different ways of talking about the same thing. Bonds that pays higher interest, or yield, because they're riskier. In this era of near-zero interest rates, junk bonds have attracted more and more investors looking for a decent return.

But remember that part about risk? Fears of a downturn in the high-yield market are growing, after a company called Third Avenue Management (http://thirdave.com/wp-content/uploads/2015/12/FCF-Shareholder-Letter-12-2015.pdf) last week blocked investors from withdrawing money from one its junk bond funds. Defaults on junk bonds are on the rise, and analysts are predicting heavy losses on the $1.2 trillion in outstanding high-yield debt.

It's such a negative term, junk, and in some ways misleading, said Edward Altman (http://www.stern.nyu.edu/faculty/bio/edward-altman), a professor at the New York University Stern School of Business.

"We've got junk mail, junk food, junk yards," Altman said, but many companies that issue high-yield debt are growing and adding jobs, "And, indeed, this is a very good way for them to raise capital, especially, of late, in the low interest rate environment."

That environment, courtesy of the Federal Reserve, has created an unintended consequence, said Duke University finance professor Campbell Harvey (http://people.duke.edu/~charvey/).

“In artificially pushing down interest rates so low, it’s induced people to take risk,” Harvey said. “Many of these people don’t really understand that they’re taking this extra risk to get the extra yield.”

They haven’t needed to understand the risks, because default rates have been fairly low. But they’re creeping up and expected to get worse. Meanwhile, the Fed appears poised to begin raising interest rates as soon as this week.

"As interest rates go up, all of a sudden the investment-grade bonds are more attractive," said Harvey. "People start selling the junk bonds, increasing the pressure on the junk bonds."

Investors could see lower returns, said Gershon Distenfeld, director of high yield investments at AllianceBernstein (https://www.abglobal.com/#/), as they have in past downturns, but he says recent fears may be overblown.

“Every time, equities go down more,” he said. “It’s, in our view, a little bit strange to say ‘I’m worried about my five or 10 percent allocation to high-yield, but I’m totally fine with 60 percent I have in stocks.’”

Reassuring, right? Then there’s this: Altman, the NYU professor, said downturns in the high-yield market are usually followed by recessions. He expects we’ll have one within a few years.

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About the author

Amy Scott is Marketplace’s education correspondent covering the K-12 and higher education beats, as well as general business and economic stories.

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