High Yield is often a misunderstood asset class and tends to receive a nominal portion of investors' asset allocation. The following attempts to de-bunk some of the common myths associated with investing in high yield bonds and to provide a constructive framework regarding the benefits of high yield.

The "D" word

"Default" is most often associated with the mention of high yield bonds and is the most significant risk associated with the asset class. The probability of default increases as the credit quality of a bond portfolio decreases and the high yield universe has experienced an average annual default rate of 4.8%[i], however, the outcome of owning the bonds of a company that has declared bankruptcy largely depends on the bonds' position in the capital structure (senior secured, senior, senior subordinated, junior subordinated) as well as the market environment. In 2011 the average recovery rate for defaulted debt was 59.4%[ii]. Assuming the bond was purchased at par, this implies a principal loss of 40.6%. Coupon payments received over the life of ownership provide an offset to the loss and could be significant (the average coupon of the high yield universe currently is 8.27%). The result is no different from that of purchasing a stock for $50 and selling it at $29.70. There may or may not be dividend cash flow to provide an offset as dividend payments are not contractual, unlike the coupon payments of bonds. The impact of default risk can be further mitigated by owning a diversified portfolio of bonds (35-40 issues) and focusing on the upper portion of the high yield universe (BB-B). During 2011, 80% of the defaults occurred where companies were rated CCC or lower at the beginning of the year. As you move down the credit curve, the probability of default increases exponentially as illustrated below:

Average Annual Default Rates *(1990-2011)*

Credit Quality	Rate*
BB	1.10%
B	1.80%
CCC	21.00%

**Source: Fitch, approximates*

Composition of the high yield market

The composition of the high yield market has also changed dramatically. In 2000, CCC rated bonds comprised 6% of the high yield market, peaked at over 30% in 2009, and was 22% at the end of 2011[iii]. Considering high yield as one homogeneous class was most probably warranted when CCC was such as small portion of the asset class; but now that it is as significant a portion of the universe with its own performance characteristics, it is important to distinguish between and among credit subsectors when determining the appropriate allocation of "high yield" for an investment portfolio. Presenting the asset class as having two distinct components, with different default probabilities and fundamental values, may warrant a re-consideration of it's weighting in an asset allocation.

CINCINNATI ASSET MANAGEMENT

Benefits of High Yield

Offsetting the risk of high yield are several potential rewards associated with investing in the asset class: **(1)** yield pick-up, **(2)** diversification of interest rate risk, and **(3)** historically superior risk/reward versus domestic equities are but a few of these benefits.

1. Yield Pick-Up. There is a positive relationship between risk and expected return. As the investor assumes more credit risk, he should be compensated accordingly with a higher yield. High yield can help to enhance income/cash flow. B rated corporate bonds currently offer a yield of 5.74% more than a Treasury bond of comparable maturity and 4.03% more than an A rated investment grade corporate bond of comparable maturity[iv].

2. Diversification of Interest Rate Risk. In addition to credit risk, an investor in fixed income securities faces interest rate risk, the potential for rising interest rates. One way to combat this risk is to include high yield in a fixed income allocation. The lower the credit quality, the less sensitive bonds become to movements in interest rates. This is most evident in the performance of Investment Grade Corporate Bonds vs. High Yield Bonds. Returns from high yield bonds are primarily driven by changes in the credit risk and less from the path of interest rates[v].

3. Historically Superior Risk/Return versus Domestic Equities. High Yield has offered comparable returns to domestic equities (S&P 500 & Russell 2000) over multiple time periods with considerably less volatility. The observation periods selected are based upon the creation of the Credit Suisse High Yield Index in 1980 and Credit Suisse Leverage Loan Index in 1992.

	Annualized Return	Annualized Volatility**	Sharpe Ratio***
1/1980 - 12/2011			
S&P 500	11.05%	17.49%	0.43
Russell 2000	10.36%	22.57%	0.34
CS High Yield Index	10.60%	9.66%	0.63
1/1992 - 12/2011			
S&P 500	7.81%	16.35%	0.37
Russell 2000	8.52%	21.76%	0.35
CS High Yield Index	8.55%	8.91%	0.66

**Source: Credit Suisse, **Standard Deviation-measure of dispersion from the mean., ***Sharpe Ratio-measure of excess return per unit of risk assumed. The unit of risk is measured by standard deviation. Higher Sharpe Ration indicates has provided a better risk/reward.*

Summary and Conclusion

Defaults do and will continue to occur in high yield. Focusing on the upper tier of the credit spectrum can significantly reduce the likelihood of incidence while recoveries on defaulted bonds, along with portfolio diversification, serve to mitigate the overall impact on portfolio performance. High yield provides attractive cash flows, can reduce interest rate risk, and has provided competitive returns when compared to domestic equities. The current asset allocation dogma of a marginal provision may need to be re-considered especially in the current environment of both low economic growth and low interest rates.

[i] *Source: Fitch for the period 1980-2011*
[ii] *Fitch U.S. High Yield Default Insight - 2011 Review; January 20, 2012*
[iii] *Credit Suisse 2012 Leveraged Finance Outlook & 2011 Annual Review, p.28*
[iv] *Barclays Daily Credit Call, March 6, 2012*
[v] *Credit Suisse 2012 Leveraged Finance Outlook & 2011 Annual Review, p.113*

Cincinnati Asset Management, Inc.
4350 Glendale-Milford Road
Suite 160
Cincinnati, OH 45242
Phone 513 554 8500
Fax 513 554 8509
www.cambonds.com