

High Yield Bonds for Allocators: Q1 2025 Update

Evaluating the use of high yield within an investment portfolio



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- Investing strategically into high yield corporate bonds can help to supplement yield or income objectives or help to diversify away from traditional equity and fixed income risks.
- Across the high yield investment universe, investors can express views across spread, credit rating, duration, and industry, allowing access to differing levels of risk and yield that may be more or less suitable for different market environments.
- Historically, the higher quality segment of this market has realized better risk-adjusted returns, where lower quality names have provided more return upside in risk-on markets.
- While distressed market environments can introduce significant price volatility, subsequent returns following periods of spread widening have, on average, fared well for higher yield investments.

Historically, investors have looked to fixed income markets to access higher quality, fixed rate returns to either supplement yield or income objectives or to help diversify away from traditional equity investments that often dominate portfolios. The growth and expansion of credit markets in recent decades has resulted in the tremendous growth of speculative-grade credit, now more commonly known as high yield. Once considered to be a more exotic, non-core fixed income asset class, high yield has now grown to serve an important strategic and tactical purpose within most investor portfolios across the risk spectrum.

This paper seeks to provide the reader with a broad overview of the high yield market, highlighting the strategic and tactical cases for high yield investing as well as addressing questions such around liquidity and market technicals, characteristics of different segments of the high yield market, and how to think about the component risks of high yield bonds. The main areas of focus of this paper can be summarized into four main categories:

1. *Strategic Allocations:* What is the strategic risk and return case for high yield within a portfolio, and what is a reasonable credit risk premium to be demanded by high yield investors?
2. *Characteristics:* What are the underlying characteristics of the high yield market, broken down by industry and by quality? How might shifting allocations based on industry or credit rating impact risk and return characteristics?
3. *Market Timing:* On a more tactical basis, when has it historically made more sense to be opportunistically overweight high yield as an asset class?
4. *Component Risks:* Between the credit spread and risk-free treasury yield, how have these component risks interacted or contributed to the total risk of the asset class?

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1 / Strategic high yield

1.1 Historical risk and return characteristics

Within the context of other equity or credit asset classes, U.S. high yield markets have historically generated similar risk-adjusted returns. Looking back to the inception of the ICE BofA U.S. High Yield Index in December of 1996, the realized Sharpe ratios of high yield, equities, and investment grade corporate bonds are coincidentally very similar. **Figure 1** shows the historical return, volatility, and Sharpe ratios for across these major US equity and credit asset classes.

Figure 1: Returns, volatility, and Sharpe ratio (12/31/1996 to 3/31/2025)

	S&P 500	ICE BofA U.S. High Yield	ICE BofA U.S. Investment Grade	Cash
Return (geometric)	9.41%	6.35%	5.05%	2.21%
Return (arithmetic)	10.24%	6.56%	5.11%	2.19%
Volatility (annualized)	15.49%	8.70%	5.89%	
Sharpe	0.44	0.43	0.42	

Source: Bloomberg L.P., DWS calculations as of 3/31/2025.
 *Cash return uses Bloomberg US Treasury Bills 13 Month Index.

Looking at returns across asset classes by calendar year, high yield returns have historically been moderate, reflecting moderate levels of risk or volatility, particularly as compared to equities and commodities. In periods of strong market returns, high yield returns have been quite positive, although not the extent of equities markets, where in negative calendar years, high yield has typically experienced less severe drawdowns versus equities. **Figure 2** shows the returns across asset classes by calendar year over the past two decades.

Figure 2: Calendar year returns across asset classes (12/31/1996 to 3/31/2025)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025 (YTD)
EM	34.0%	32.1%	39.4%	13.7%	78.5%	26.9%	9.8%	18.2%	38.8%	13.7%	1.4%	21.3%	37.3%	1.8%	31.5%	20.0%	28.7%	16.1%	26.3%	25.0%	8.9%
Commodity	21.4%	26.3%	16.2%	1.8%	57.5%	18.9%	7.5%	17.3%	32.4%	7.5%	0.8%	17.5%	25.0%	0.9%	25.5%	18.4%	27.1%	1.5%	18.2%	11.5%	6.9%
EAFE	13.5%	18.4%	11.2%	-6.8%	31.8%	16.8%	4.4%	16.4%	22.8%	5.1%	0.0%	12.0%	21.8%	-2.2%	22.0%	18.3%	14.8%	-11.2%	16.9%	8.2%	2.9%
S&P 500	4.9%	15.8%	9.0%	-26.4%	27.2%	15.2%	2.1%	16.0%	7.4%	4.9%	-0.6%	11.8%	14.6%	-2.3%	18.4%	9.8%	11.3%	-12.5%	13.5%	7.5%	2.9%
US SC	4.6%	11.8%	5.5%	-33.8%	26.5%	15.1%	0.1%	15.6%	0.0%	2.5%	-0.8%	11.2%	7.5%	-4.4%	14.4%	8.0%	5.4%	-14.5%	9.8%	5.4%	2.4%
Cash	3.0%	4.8%	4.8%	-35.6%	19.8%	9.5%	-4.2%	10.4%	-1.5%	0.0%	-4.4%	6.0%	6.5%	-11.0%	14.2%	7.8%	0.0%	-15.4%	8.4%	5.3%	1.0%
US Treasuries	2.8%	4.4%	4.6%	-37.0%	18.9%	7.8%	-12.1%	2.0%	-2.6%	-2.2%	-4.6%	1.0%	2.3%	-11.2%	7.7%	6.2%	-1.0%	-18.1%	5.1%	2.8%	0.9%
US HY	2.7%	3.1%	2.2%	-43.4%	0.1%	5.9%	-13.3%	0.1%	2.7%	-4.9%	-14.9%	1.0%	1.7%	-13.8%	6.9%	0.5%	2.3%	-20.1%	4.1%	2.8%	0.9%
US IG	2.0%	2.1%	-1.6%	-53.3%	-3.6%	0.1%	-18.4%	-1.1%	-9.5%	-17.0%	-24.7%	0.3%	0.8%	-14.6%	2.2%	-3.1%	-2.5%	-20.4%	-7.9%	0.6%	-9.5%

Source: Bloomberg L.P., DWS calculations as of 3/31/2025.

Historical cross-asset correlations show quite intuitive results as well. Whereas high yield corporate bonds are fixed income instruments, the ability of corporations to service their debt is largely a function of corporate earnings and is reflected in stronger positive correlations to equities and weaker correlations to sovereign bonds and cash. **Figure 3** shows total return correlations across various asset classes over the past two decades.

Figure 3: Correlation matrix (3/31/2005 to 3/31/2025)

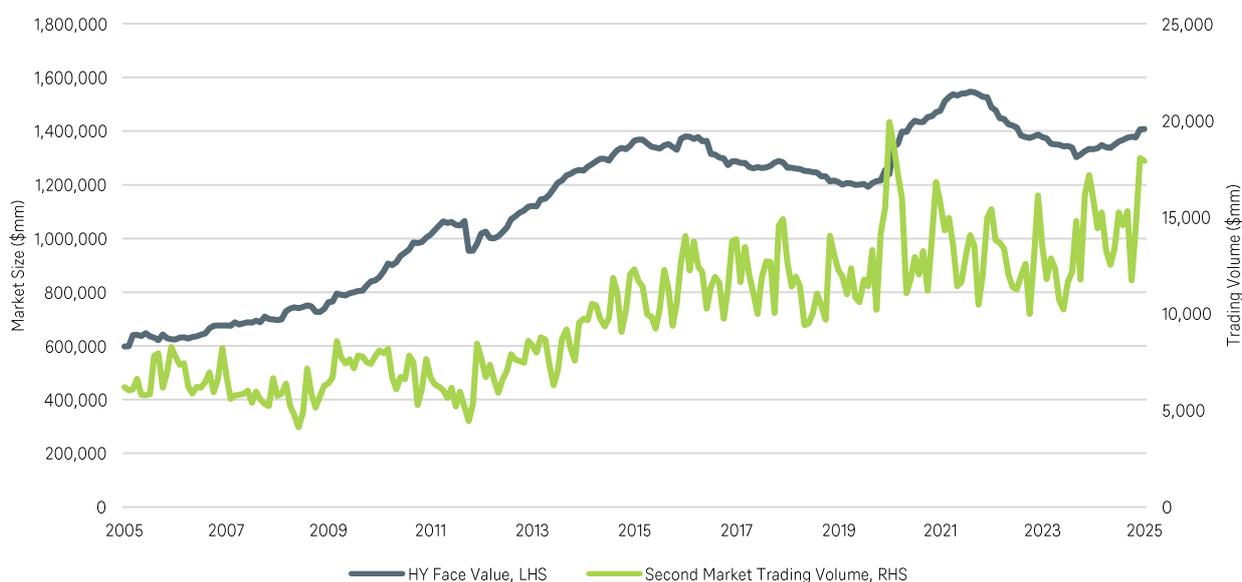
	US HY	S&P 500	EAFE	EM	US SC	Commodities	US Treasuries	US IG	Cash
US HY	1.00	0.73	0.02	0.71	0.70	0.49	(0.07)	0.66	(0.11)
S&P 500	0.73	1.00	0.02	0.73	0.90	0.45	(0.15)	0.42	(0.10)
EAFE	0.02	0.02	1.00	(0.02)	0.03	(0.01)	(0.07)	(0.06)	(0.07)
EM	0.71	0.73	(0.02)	1.00	0.69	0.59	(0.10)	0.47	0.03
US SC	0.70	0.90	0.03	0.69	1.00	0.42	(0.23)	0.33	(0.10)
Commodities	0.49	0.45	(0.01)	0.59	0.42	1.00	(0.18)	0.23	(0.01)
US Treasuries	(0.07)	(0.15)	(0.07)	(0.10)	(0.23)	(0.18)	1.00	0.58	0.13
US IG	0.66	0.42	(0.06)	0.47	0.33	0.23	0.58	1.00	(0.05)
Cash	(0.11)	(0.10)	(0.07)	0.03	(0.10)	(0.01)	0.13	(0.05)	1.00

Source: Bloomberg L.P., DWS calculations as of 3/31/2025.

1.2 Liquidity

As high yield liquidity conditions have improved (high yield now makes up roughly 4% of the investible fixed income universe in the US), with significant increases in market depth and cash bond transaction volumes, managing portfolio risk has been made easier. Figure 4 shows the significant growth in both the size and underlying liquidity of the cash high yield market.

Figure 4: High yield (HY) market size and trading volumes (3/31/2005 to 3/31/2025)

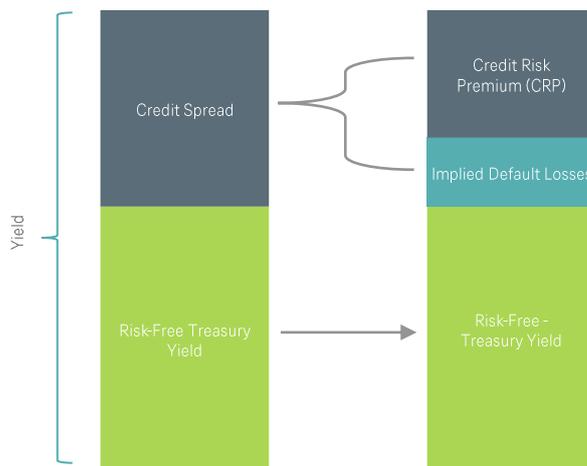


Source: Bank of America Research, FINRA TRACE as of 3/31/2025.

1.3 Spreads and default losses

Over a strategic time horizon, yields are the primary driver of long-term returns across most fixed-income asset classes. The same is true of high yield bonds, where yield is comprised of a risk-free component and a spread component that compensates an investor for the risk of issuer default. Due to its more speculative nature, at least relative to investment grade issuers, speculative-rated credit spreads generally embed a risk of the issuer defaulting and the corresponding losses from the partial repayment as well as an additional compensation or return premium for the risk or uncertainty associated with credit loss potential. Figure 5 illustrates the simple decomposition of the yield into its three contributing components: 1. Risk free rate, 2. Credit risk premium and 3. Implied default losses.

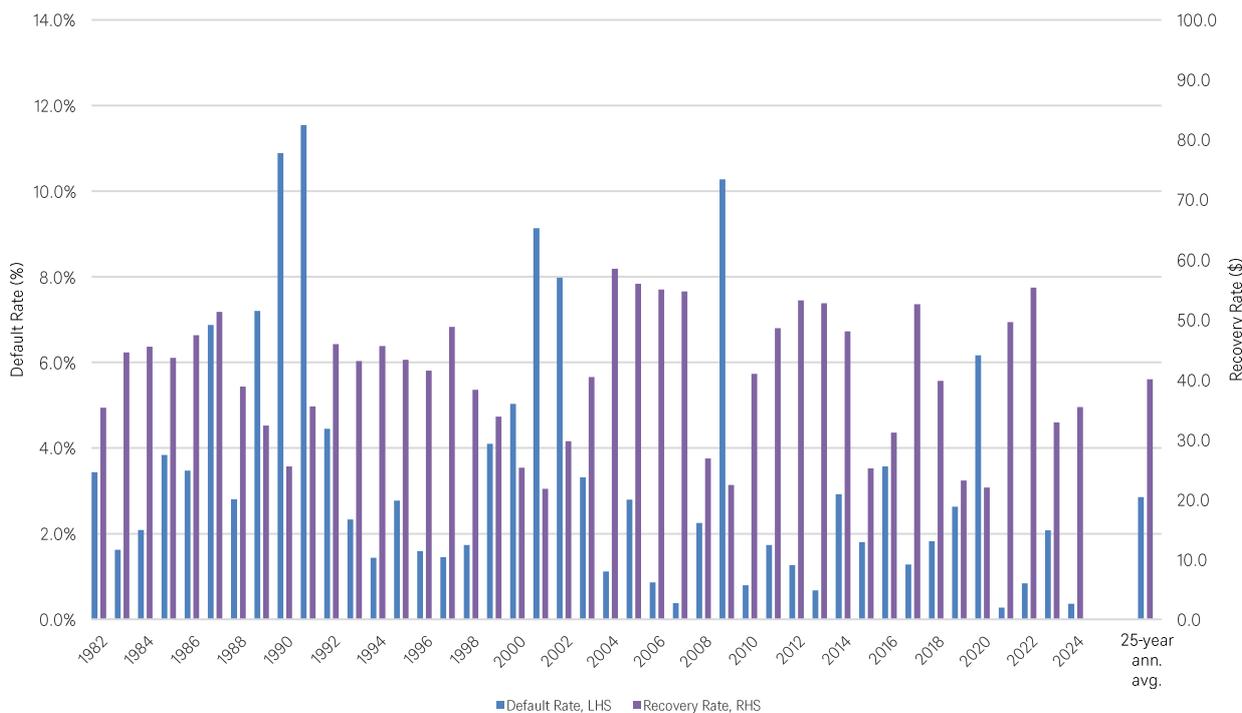
Figure 5: Decomposition of high yield index yield



Source: DWS Investment Management GmbH.

Over the past 25 years, the average annual default rate across the high yield universe has been between 2.5 and 3%, with an average recovery rate of slightly below \$40 based on a par value of \$100. This roughly 60% default loss rate from par combined with the 2.5 to 3% default rates equates to roughly 1.5 to 2% default losses per annum assuming par value for the defaulted securities. Figure 6 shows the historical trailing-twelve-months default rate and recovery rate from Moody's Investor Services.

Figure 6: Historical default rate and recovery rate (12/31/1981 to 12/31/2024)



Source: JP Morgan Research as of 12/31/2024.

2 / High yield characteristics

2.1 High Yield Ratings

Fundamentally, debt issuers are assessed by ratings agencies based on the likelihood that they repay their debt obligations. High yield, sometimes referred to as speculative grade, ranges in credit rating from BB to C (or in some cases, unrated), with each rating representing between a low and high probability of issuer default. According to analysis from S&P Global Fixed Income Research, between 1981 and 2017, the probability of default over a 5-year time horizon was roughly 6.5% for BB-rated issues and 46.2% for CCC/C-rated issues¹

Figure 7: Comparison between Fitch, S&P, and Moody's ratings categories and descriptions

Moody's	S&P	Fitch	Rating Definitions (Moody's)
Aaa	AAA	AAA	Minimal risk
Aa1	AA+	AA+	Very lower credit risk
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	Very lower credit risk
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	Medium credit risk
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	Substantial credit risk
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	High credit risk
B2	B	B	
B3	B-	B-	
Caa1	CCC+	CCC+	Very high credit risk
Caa2	CCC	CCC	
Caa3	CCC-	CCC-	
Ca	CC	CC	In or near default, possible recovery
C	C	C	In default, little prospect for recovery
	SD	DDD	
	D	DD	
		D	

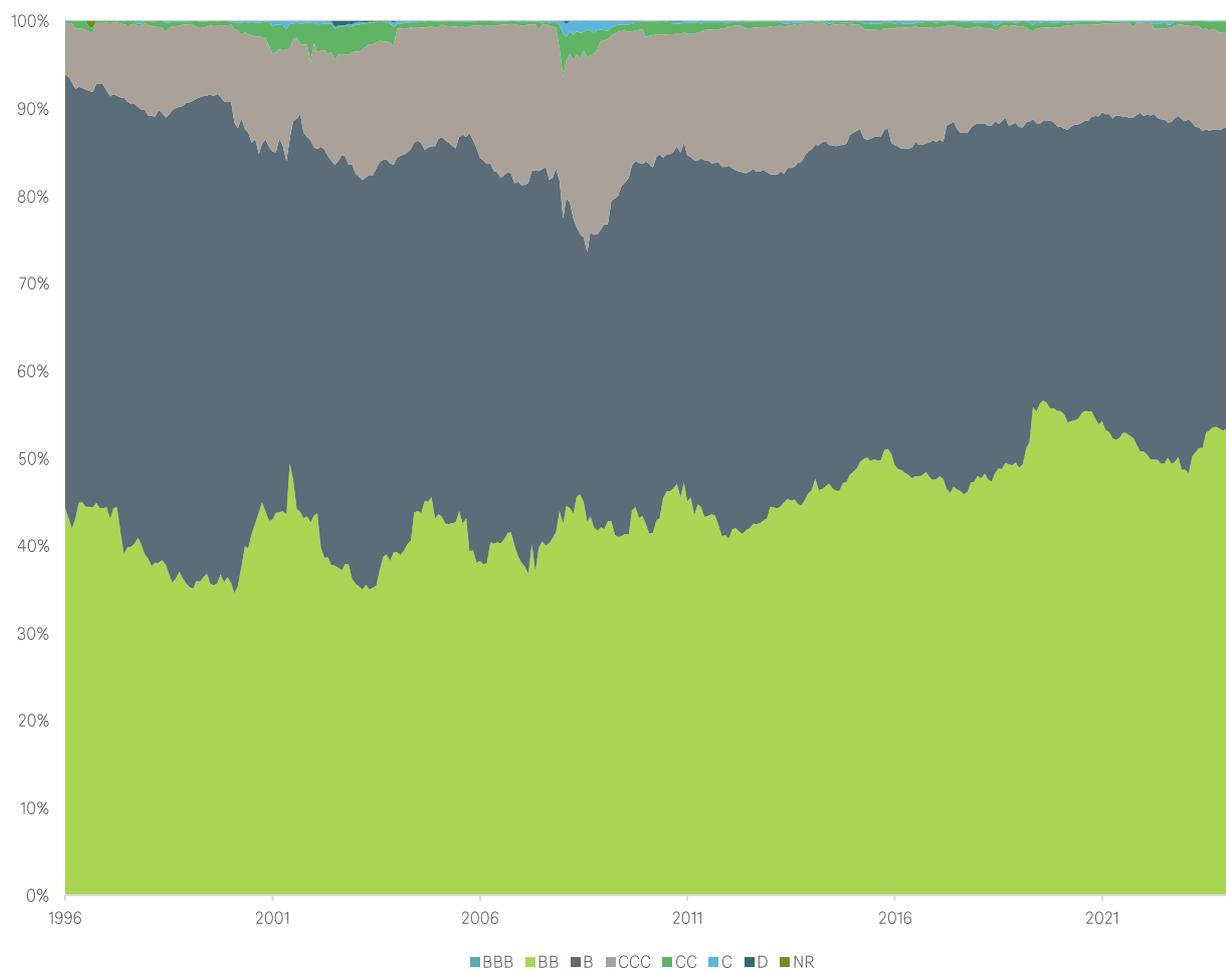
Source: Fitch Ratings Inc., S&P Global Ratings, Moody's Investor Services.

The ICE BofA U.S. High Yield Index universe has historically consisted of relatively proportionate weights to BB and B-rated securities, with CCCs making up, on average, just over 10% of the index. In recent years, the ratings composition has migrated higher in quality, where BB-rated bonds now make up nearly 54% of the index and B-rated bonds around 35%, with the balance largely consisting of between 10 and 11% in CCC-rated securities.

Figure 8 shows the historical ratings composition of the ICE BAML U.S. High Yield index.

¹ <https://www.livewiremarkets.com/wires/quantifying-the-risk-of-bonds-with-s-p-credit-ratings>

Figure 8: High yield ratings composition (12/31/1996 to 3/31/2025)



Source: ICE BAML Indices as of 3/31/2025.

Looking at returns and Sharpe ratios across credit ratings, it's apparent that seldom does the CCC and lower segment of the high yield market generate superior risk-adjusted returns relative to BB/B-rated credits. Only in very strong credit market rallies has the risk-adjusted return of the CCC and lower-rated securities exceeded the broader high yield index as shown in Figure 9.

Figure 9: Returns, volatility, and Sharpe ratio (12/31/1996 to 3/31/2025)

	ICE BofA US High Yield Index	ICE BofA BB US High Yield Index	ICE BofA Single-B US High Yield Index	ICE BofA BB-B US High Yield Constrained Index	ICE BofA CCC & Lower US High Yield Index	Bloomberg U.S. Tr Bills: 1-3 Months TR Index Value Unhedged
Return (geometric)	6.35%	6.12%	6.05%	7.17%	6.72%	2.21%
Return (arithmetic)	6.56%	6.27%	6.12%	7.59%	7.51%	2.19%
Volatility (annualized)	8.70%	7.82%	6.73%	11.25%	13.88%	0.61%
Sharpe ratio	0.43	0.45	0.50	0.41	0.33	-

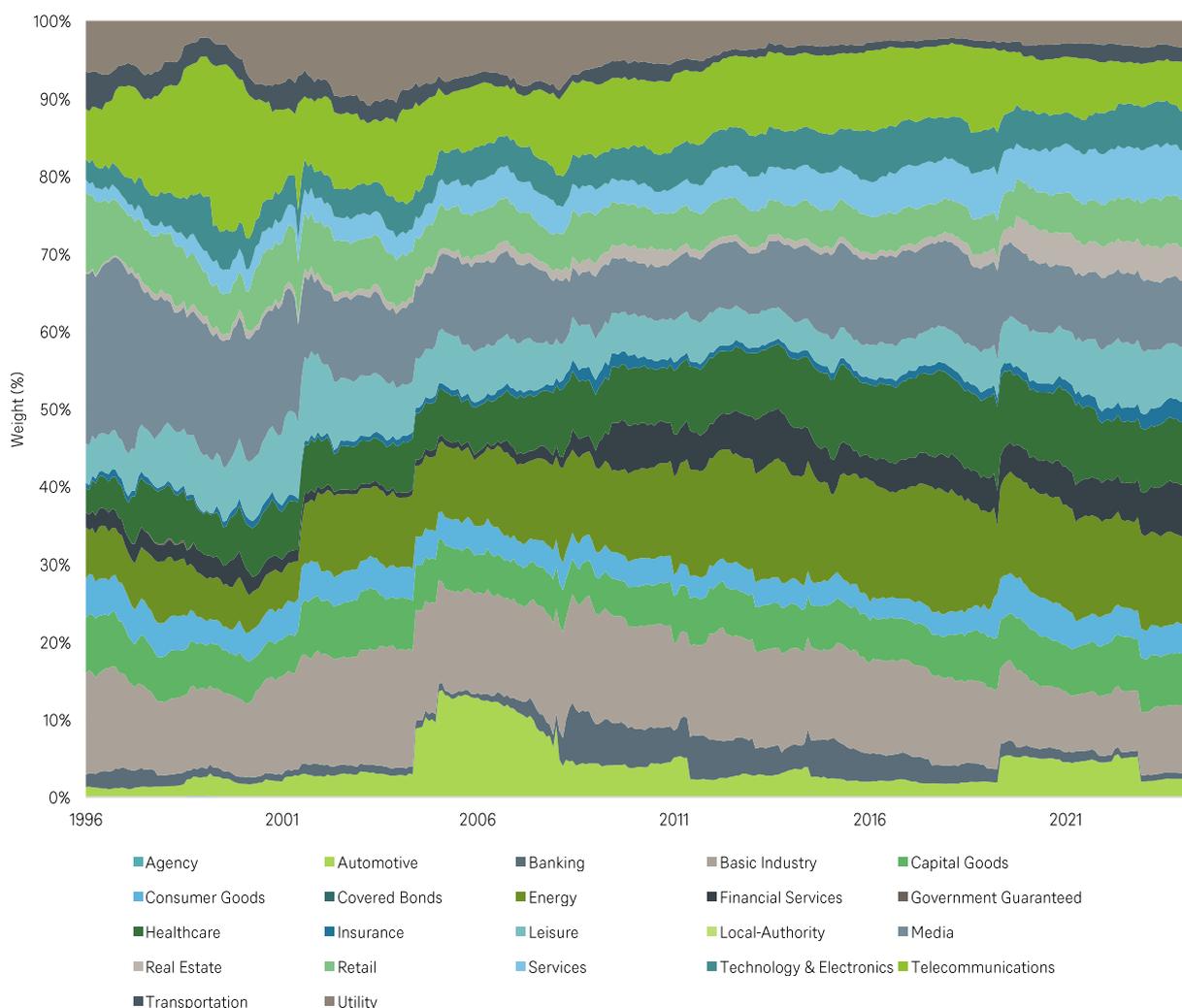
Source: ICE BAML Indices, Bloomberg L.P., DWS calculations as of 3/31/2025.
 *Cash return uses Bloomberg US Treasury Bills 1-3 Month Index.

2.2 High Yield Industries

The industry composition of the high yield universe has changed over the past three decades, where energy has grown to now exceed 11% of the high yield index even after the energy default cycle in 2016. On the contrary, retail has shrunk from just about 10% in 1996 to barely 6% of the current index, and Media, once representing over 22% of the index, is now under 9% of the high yield universe.

Generally macroeconomic trends have driven the shifts in industry composition across the high yield universe, although the size and the creditworthiness of companies has also influenced the breakdown between investment grade and high yield composite indices. Telecommunications and media companies such as Nextel and Adelphia, once sizeable issuers within the high yield universe, are now either merged with other firms or no longer operating, whereas the boom in US energy production has made Houston-based Occidental Petroleum one of the largest high yield issues in recent years. Figure 10 shows the historical changes in the industry composition of the broad high yield index.

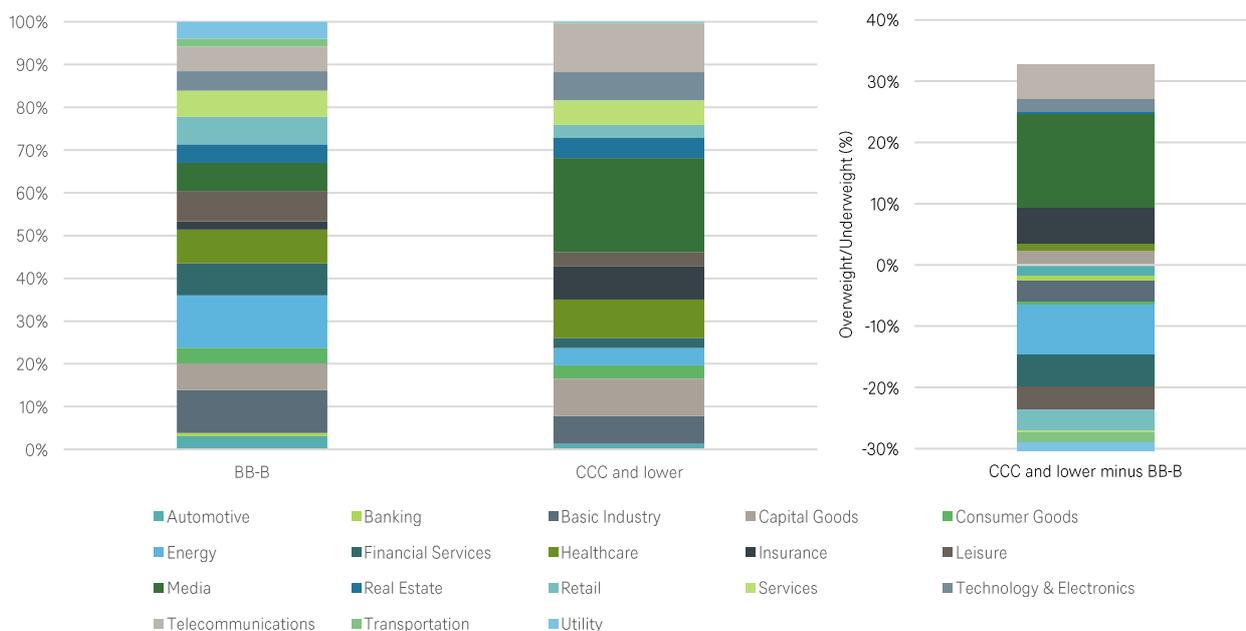
Figure 10: High yield industry composition (%) (12/31/1996 to 3/31/2025)



Source: ICE BAML Indices as of 3/31/2025.

The CCC and lower segment of the market can, at times, be dominated by single issuer downgrades or industry-specific turmoil, which can drive significant differentials in industry composition between higher quality and lower quality indices. Figure 11 shows the most recent industry weightings for the BB-B segment of the high yield market as compared to the CCC and lower segment.

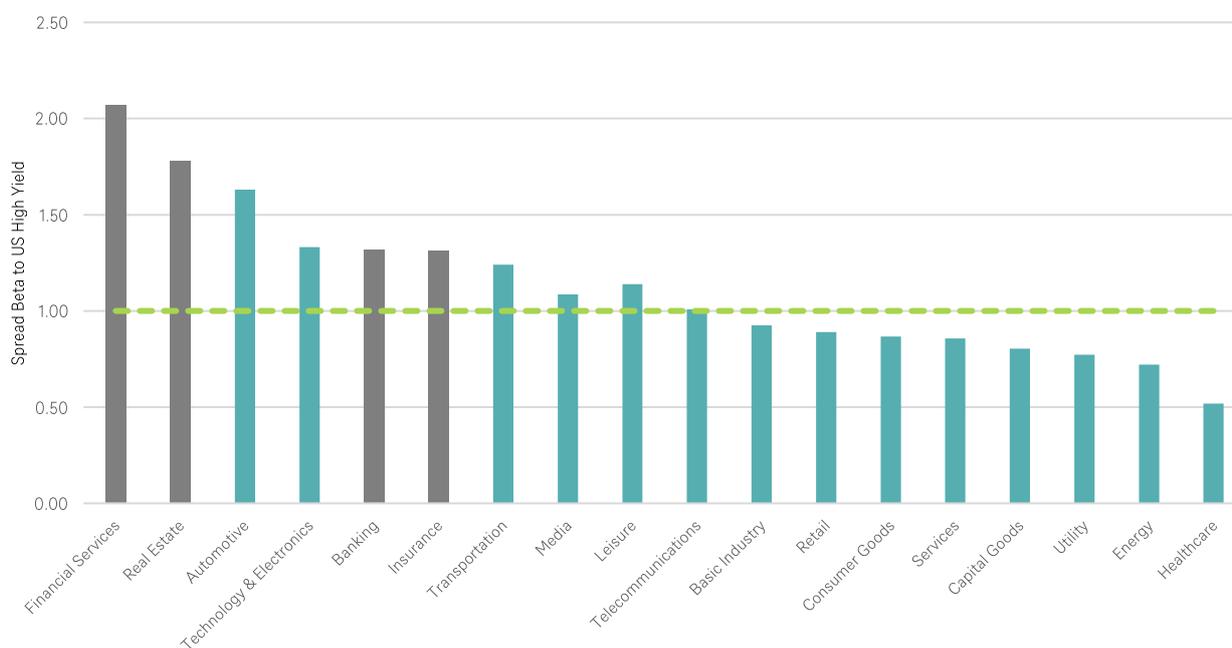
Figure 11: High yield industry weights by rating (3/31/2025)



Source: ICE BAML Indices as of 12/31/2023.

While industry-specific risks factors can be influenced by idiosyncratic economic or market events, as with equity markets, certain high yield industries have empirically demonstrated more defensive behaviors in terms of their credit spreads. Looking across high yield industries, we can show which areas of the market have historically experienced the highest and lowest spread betas, or directional sensitivity to the spread behavior in the broader high yield market. Figure 12 shows the historical spread betas by industry, highlighting the empirically higher spread beta of financials-related industries.

Figure 12: Options-adjusted spread beta by industry (12/31/1996 to 3/31/2025)



Source: ICE BAML Indices, DWS calculations as of 3/31/2025.

5 / Conclusion

For investors across capital return and income-based strategies, high yield is an integral component of a well-diversified portfolio, offering attractive all-in yield levels that combine risk-on exposures with sensitivity to interest rates. As a fixed income instrument, high yield bonds have realized strong empirical risk-adjusted returns while helping to diversify away from traditional equity or core fixed income-only portfolios. These characteristics have demonstrated the value of high yield as a strategic allocation in a multi-asset or fixed-income portfolio.

As high yield has gained prevalence in investor portfolios, the size and depth of the high yield market has expanded considerably, allowing both active and index-based approaches to high yield investing to navigate market conditions more easily, particularly when liquidity was more historically challenged. For investors, the ability to dynamically reallocate in and out of high yield has made it easier to express tactical views when yields and spreads have become more attractive.

Furthermore, the depth of the high yield market has also allowed investors to take more nuanced views on their high yield investments. Tilting into or away from certain industries, expressing quality preferences across ratings or spreads/yields to reflect either strategic or tactical market views can help investors more thoughtfully gain exposure to the high yield asset class with greater consideration for management of portfolio opportunities and risks.

To view a more comprehensive version of this piece, [click here](#).

Glossary

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

The **Bloomberg US Treasury Bills 1-3 Month Index** tracks the market for Treasury bills Issued by the U.S. government with time to maturity between 1- 3 months.

Core fixed income refers to a capital preservation-based approach to allocating to investment grade-rated bonds.

A **corporate bond** is a bond issued by a corporation in order finance their business.

Correlation is a measure of how closely two variables move together over time.

Correlation Breakeven is a measure of the correlation between the local equity and the currency such that the unhedged and hedged index volatilities are equivalent.

A **credit rating** is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

Credit Risk (Default Risk) refers to the risk that principal or interest may not be paid to the investor when due.

The **credit risk premium** or **excess spread** is the expected return on a credit investment minus the return that would be earned on a risk-free investment.

Credit migration refers to the ratings of a bond moving higher or lower based on assessed changes in the fundamental health of the issuer and its ability to repay its debt obligations based on the review of credit agencies.

Credit **spread** refers to the excess yield various bond sectors offer over financial instruments with similar maturities. When spreads widen, yield differences are increasing between bonds in the two sectors being compared. When spreads narrow, the opposite is true.

Default losses are investment losses in price based on an issuer default and inability to repay principal.

A **distressed** strategy is an investment strategy that seeks profit by investing in companies or other investment opportunities that face financial difficulties.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate or credit spread changes.

Equity market refers to a market in which equities (stocks) are traded. The term can be used to refer to an actual market (e.g. the New York Stock Exchange) or to general trends in equity trading. Equities are securities which certify rights of ownership of (parts of) a company.

Exchange traded funds (ETFs) are a sort of exchange traded product (ETP) that can hold a variety of underlying assets and that can be traded on a stock market.

Fixed Income broadly refers to those types of investment security that pay investors fixed interest or dividend payments until its maturity date.

High yield (HY) bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

The **ICE BofA U.S. Investment Grade Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

The **ICE BofA U.S. High-Yield Index** tracks the performance of dollar-denominated below investment grade, including zero-coupon and payment-in-kind (PIK) bonds.

Interest rate-hedging refers to a technique to offset the risks of adverse interest rate movements on a financial instrument

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

NAV (Net Asset Value) is usually determined at 4:00 pm Eastern Time on each day that a fund's exchange is open for trading. It is calculated by dividing a fund's total net assets less total liabilities by the number of shares outstanding.

The **option-adjusted spread ("OAS")** is a commonly used measure for fixed-income securities with embedded options (call, put or sink). It makes the yield of such instruments comparable to similar securities without such embedded options.

Typically, the OAS for credit sensitive instruments is quoted vis-à-vis the respective Swap spread curve. Technically, option pricing methods are used to evaluate the instruments with embedded options.

Par value refer to the original or face value of the bond.

The **recovery rate** is the extent to which principal and accrued interest on a debt instrument can be recovered in default, expressed as a percentage of the instrument's face value.

Risk-on refers to a market environment where investors are willing to take risks, often when market returns are strongly positive.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

Return (arithmetic) is the simple average return.

Return (geometric) is the return compounded over time.

The **return premium** refers to the excess return over a reference market that is associated with the risk premium.

The **Sharpe ratio** puts an asset's excess return (the return above the risk-free rate) in relation to the asset's risk as measured by its standard deviation.

Skew is a measure of the asymmetry of the distribution of a data set.

Sovereign bonds are bonds issued by governments.

Standard deviation is often used to represent the volatility of an investment. It depicts how widely an investment's returns vary from the investment's average return over a certain period.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Yield refers to the ratio of cash outflows to cash inflows from an investment.

Appendix

The following indexes were used to proxy the asset classes mentioned in the paper:

Asset Class	Index
S&P 500	S&P 500 Net Total Return USD Index
US Small Cap	Russell 2000 Net Total Return USD Index
EAFE Equities	MSCI Europe, Australasia, and Far East (EAFE) Net Total Return USD Index
EM Equities	MSCI Emerging Markets Daily Net Total Return USD Index
Commodity	Bloomberg Commodity Index Total Return
US IG	ICE BofA U.S. Corporate Index
US HY	ICE BofA U.S. High Yield
US Treasuries	Bloomberg US Treasury Total Return Unhedged USD
Cash	Bloomberg U.S. Treasury Bills: 1-3 Months Total Return Index Value Unhedged

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