Tight Spreads Shouldn't Diminish High Yield's Appeal

Artisan Partners Credit Team

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Insights

A R T I S A N P A R T N E R S

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As an active manager with high degrees of freedom, the Artisan Partners Credit Team believes the disciplined execution of its process will enable it to build a portfolio of securities that can perform well regardless of the market environment. The team's commitment to deep fundamental analysis and a capital-structure-agnostic view are key attributes in identifying opportunities for Artisan High Income Fund.

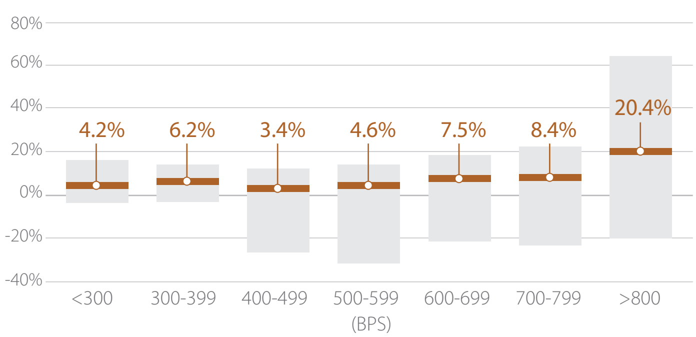
While it could be argued that the opportunity in credit markets is less interesting than it was at previous points in the current credit cycle, the team believes the benign credit backdrop of strong economic momentum and low default activity should create a favorable environment for high yield investors going forward.

Tight Spreads Shouldn't Diminish High Yield's Appeal

The essentially uninterrupted rally in risk assets over the last few years has pushed a range of asset prices to new highs, helped by improving economic growth, steadily rising corporate profits and historically low volatility. However, after years of strong returns for high yield bonds, investors are asking whether currently low yield spread levels indicate the asset class is fully (or near fully) valued and the opportunity for continued strength has passed.

It's true, high yield bond spreads—which measure the additional compensation investors require for the risk of default relative to a Treasury security of similar maturity—are below their long-term averages. Yet, tight spreads have not necessarily been a precursor to wider spreads in the future or a warning sign of negative returns to come, as we'll discuss. The key takeaway is: Spreads are only one of many variables to consider when investing in the asset class, and in our opinion, today's favorable environment for credit fundamentals suggests high yield credit remains an attractive asset class.

Exhibit 1: One-Year Range of Forward Returns by Spread Level



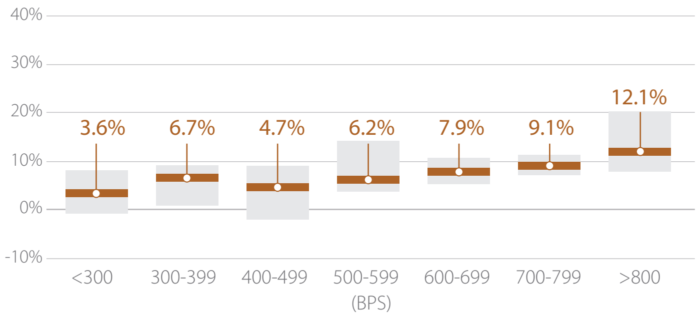
Source: ICE BofAML US High Yield Index. **Past performance is not a reliable indicator of future results.** Total returns presented were calculated using monthly option-adjusted spreads measured in basis points for the ICE BofAML US High Yield Index for the period December 31, 1996 to March 31, 2018. Spreads are based on month-end values. The shaded area represents the full range of 1-year annualized forward returns; the maroon line indicates the average return within the range.

Exhibit 1 shows the historical average and range of forward 12-month returns ("forward returns") for the ICE BofAML US High Yield Index based on month-end spread levels at the beginning of the investment period. History does show that when spreads have been wide, all else equal, the ICE BofAML High Yield Index has produced above-average returns. For example, since 1997, when spreads were between 700 and 799 basis points, the Index has averaged 8.4% based on forward returns, while spreads in excess of 800bps have averaged 20.4%—albeit with a great deal of variability, as illustrated by the wide range of outcomes in Exhibit 1. Yet, forward returns following lower spreads have also been compelling—forward returns when starting spreads were between 300 and 399 bps have averaged 6.2%.

Returns have historically been higher on average when starting spreads were very wide. However, lower spreads have not necessarily produced worse average annual forward returns—particularly for investors with longer time horizons. Again, the average forward 12-month returns when starting spreads were between 300-399bps (6.2%) has exceeded returns when spreads were between 400-499bps and 500-599bps (3.4% and 4.6%, respectively). Similarly, when spreads were less than 300bps, average forward returns of 4.2% have exceeded the average return when spreads were between 400-499bps and weren't that far off from returns following starting spreads of 500-599bps. This challenges conventional wisdom that an incremental increase in spreads leads to an incremental increase in average returns.

Another key consideration is that in reviewing a longer-term range of annualized ICE BofAML High Yield Index returns, data indicate that maintaining a long-term time horizon has historically increased the likelihood of positive outcomes. For credit investors, an extended holding period has tended to allow more time for the market to address short-term fluctuations related to valuation concerns and tight spread levels. Further, a longer time horizon allows coupon income—which has historically accounted for most of the high yield market's total return—to compound over time. As Exhibit 2 shows, extending the time horizons from 12 months to 5 years has historically led to higher average forward returns, less return variability across spread levels and a collapsing range of outcomes.

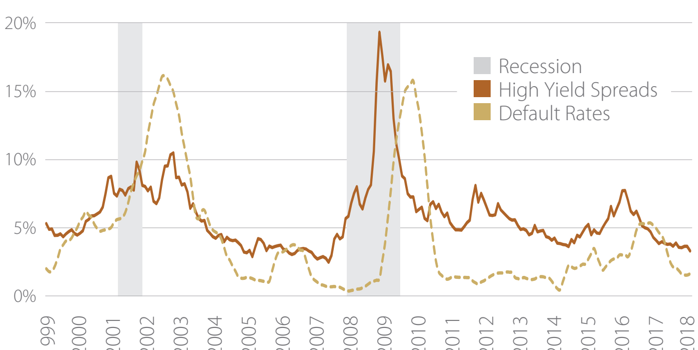
Exhibit 2: 5-Year Range of Annualized Forward Returns by Spread Level



Source: ICE BofAML US High Yield Index. **Past performance is not a reliable indicator of future results.** Total returns presented were calculated using monthly option-adjusted spreads measured in basis points for the ICE BofAML US High Yield Index for the period December 31, 1996 to March 31, 2018. Spreads are based on month-end values. The shaded area represents the full range of 5-year annualized forward returns; the maroon line indicates the average return within the range.

Ultimately, a company's inability to service its debt is the biggest threat to high yield bond returns, and this risk tends to be best reflected in spread levels. Spreads are most likely to widen when the economy slows and financial stress on corporate issuers is expected. And when spreads are widest, they're reflecting significant economic uncertainty, rising corporate default rates and, subsequently, the possibility of losses for high yield investors. This often coincides with the latter stages of a contraction, and those risk assets that were most depressed have often bounced back the hardest in the subsequent recovery, leading to the strong historical returns seen in Exhibit 1. Conversely, when spreads are low as they are today, they tend to be reflecting an optimistic outlook for credit fundamentals—an environment where corporate defaults are few, negative credit events are rare and the risk of significant drawdown for high yield investors relatively low.

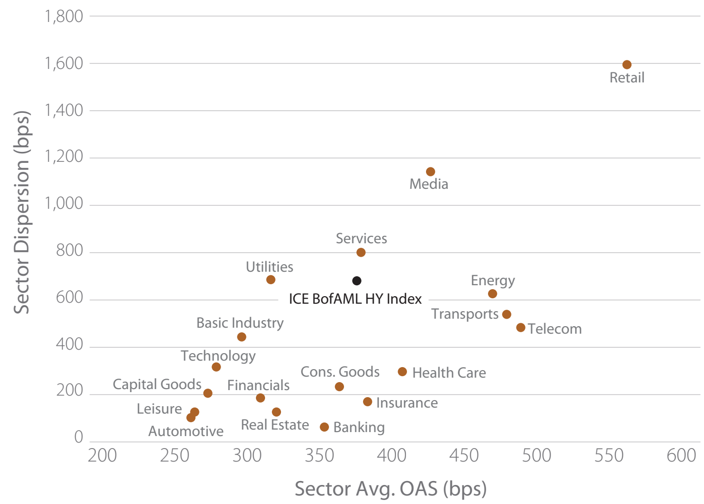
Exhibit 3: A Benign Credit Environment—*High Yield Spread and Corporate Default Rates*



Source: ICE BofAML. As of 31 March 2018. **Past performance is not a reliable indicator of future results.** Default rate measured by the 12-month par-weighted default rate in the ICE BofAML US High Yield Index. High yield spreads are represented by the ICE BofAML US High Yield Index option-adjusted spreads.

Given today's stable macroeconomic backdrop, we believe the environment remains supportive for high yield bond investors. With the high yield 12-month trailing corporate default rate notably down from its recent peak in 2016, corporate defaults are well below their long-term average and are a big contributor to today's tight spread environment. Combined with stimulative fiscal policy and recently passed corporate tax cuts, credit conditions are benign and are likely to remain so for another few years, in our opinion. While past performance isn't indicative of future returns, history has shown that lower spread levels are not a barrier to compelling investment returns.

Exhibit 4: Intra-Sector Spread Dispersion



Source: ICE BofAML US High Yield. Data presented as of March 31, 2018. Dispersion calculated as standard deviation of sector constituents' option-adjusted spread in the ICE BofAML US High Yield Index.

Opportunities Remain Despite Tight Market

Fortunately for high yield investors, lower spreads don't necessarily translate to fewer opportunities as the tight market has been disguising a growing opportunity set. Rising idiosyncratic challenges across sectors and securities are causing significant intra-sector dispersion (Exhibit 4), indicating the market is becoming more discerning between perceived winners and losers. For instance, the growing threat of disruption by e-commerce giant Amazon has led to a notable divergence between traditional retailers and those companies that are equipped to handle the current challenges of the new retail environment. In energy, the oil bust of 2015 has forced investors to become more focused on return of capital rather than growth at any cost, leading to notable bifurcation between high-quality risk and low-quality risk. And in telecom, significant dispersion has emerged between legacy wireline providers facing secular headwinds and the faster-growing wireless segment.

For active managers with a high-conviction and research-intensive process, these industry disruptions and company-specific issues can lead to alpha-generating opportunities. Careful credit selection can identify those credit profiles that have been unnecessarily punished from industry-related selling and are better positioned for outperformance. Similarly, diligent credit pickers can identify those companies with deteriorating credit fundamentals that are likely to worsen. With most of these sectors trading cheaper than the overall index, there are significant pockets of opportunity that get overshadowed by broader industry headwinds.

Artisan High Income Fund: Our Differentiators

- **Capital Structure:** Flexibility to invest across the debt capital structure in both high yield bonds and bank loans, as dictated by relative value
- **Ratings Agnostic:** A philosophy that is ratings-aware but agnostic, resulting in atypical and idiosyncratic sector exposure
- **Business Quality:** An adherence to business quality as a primary driver of value, without compromising for yield
- **Identifying Value:** A preference to act as a cash flow lender at par and asset-backed lender in times of market, sector or company-specific stress
- **High Conviction:** A high-conviction portfolio built upon deep, fundamental analysis and thoughtful credit selection

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Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by calling 800.344.1770. Read carefully before investing.

Fixed income investments entail credit and interest rate risk. In general, when interest rates rise, fixed income portfolio values fall and investors may lose principal value. High income securities (junk bonds) are fixed income instruments rated below investment grade. High income securities are speculative, have a higher degree of default risk than higher-rated bonds and may increase the Portfolio's volatility. The Portfolio typically invests a significant portion of its assets in lower-rated high income securities (e.g., CCC). Loans carry risks including the insolvency of the borrower, lending bank or other intermediary. Loans may be secured, unsecured, or not fully collateralized, and may infrequently trade, experience delayed settlement, and be subject to restrictions on resale. Private placement and restricted securities are subject to strict restrictions on resale and may not be able to be easily sold and are more difficult to value. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. The use of derivatives may create investment leverage and increase the likelihood of volatility and risk of loss in excess of the amount invested.

This material represents the views of the portfolio manager as of 31 March 2018. The views and opinions expressed are based on current market conditions, which will fluctuate and those views are subject to change without notice. While the information contained herein is believed to be reliable, there no guarantee to the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.

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ICE BofAML US High Yield Master II Index measures the performance of below investment grade $US-denominated corporate bonds publicly issued in the US market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

Par-weighted default rate measures the dollar value of defaults (based on the par value of issued securities) as a percentage of the overall market that failed to make scheduled interest or principal payments in the prior 12 months. **Spread** is the difference between two bonds of similar maturity but different credit quality. **Option-adjusted spread (OAS)** is the spread relative to a risk-free interest rate, usually measured in basis points, that equates the theoretical present value of a series of uncertain cash flows of an instrument to its current market price. OAS can be viewed as the compensation an investor receives for assuming a variety of risks (e.g. liquidity premium, default risk, model risk), net of the cost of an embedded options.

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