Denver Investments
Institutional

Investor Preference for Quality High Yield in 2016….and Beyond?

Denver Investments' Fixed Income team has, over the past several years, discussed with investors its expectations that its High Yield Fixed Income Product would perform well relative to its peer group during periods of high-yield market turbulence.

When high yield market returns are strong with little differentiation amongst issuers or rating categories, investors are often lulled into taking on more risk. Since 2009, the accommodative policies of global central banks, low rates of inflation and a relatively benign default rate environment steered investors to "reach for yield" within their bond allocation, perhaps taking on more susceptibility to high yield market volatility. While the timing of market volatility may be difficult to project, it is readily apparent that such disadvantageous periods have occurred often and that investors are prone to forget the lesson that such volatility provides time and time again.

During 2014 and 2015, the high yield market experienced two periods of weakness, separated by a limited period of market strength. Within each episode, investors became more nervous about an eventual move to a more normalized policy by the Fed. This, along with slowing global growth and fallout from a dramatic decline in the price of crude oil, caused a shift in investors' appetite for risk. The resulting shift in risk appetite and accompanying sudden change in valuations throughout the high yield market was akin to the previous "risk-off" movement that had unfolded just as recently as 2011, causing a differentiation of returns across rating categories and the favoring of higher rated securities within the high yield asset class. Higher quality high yield has historically exhibited less volatility during such negative return environments.

Denver Investments' High Yield Fixed Income product is focused on the higher quality segments of the high yield market (as represented by Ba rated issuers) and thus has been positioned to offer competitive yield with more limited downside price volatility compared to traditional high-yield investment options. The product's performance since the financial crisis, and the relative return achieved within the 2011, 2014 and 2015 annual periods of heightened volatility, has met our expectations.

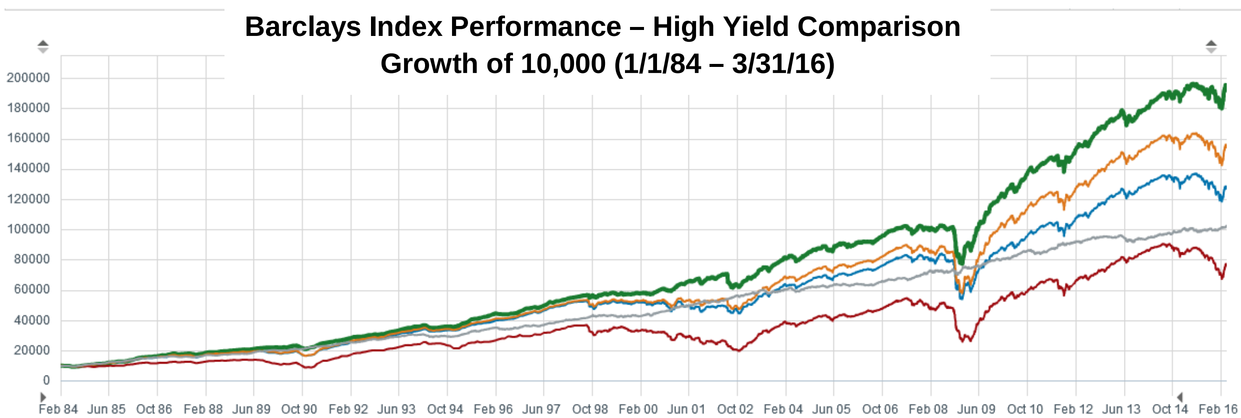
The High Yield Fixed Income product's return and volatility data over the last seven years is illustrated within the below table:

Return & Volatility Measures 7 Years Ended 3/31/2016	**Annualized Return**	**Standard Deviation**	**Sharpe Ratio**	**Sortino Ratio**
Denver Investments High Yield Fixed Income	12.00%	6.37%	1.87	5.36
eVestment High Yield Fixed Income Universe Median	11.37%	7.42%	1.55	3.26

Past performance does not guarantee future results.

The product's investment process entails intensive credit analysis by which we evaluate yield versus risk, through business cycles, and the logical result is a larger weighting of higher-rated, high-yield issues. Most importantly, we believe this strategy works over the long term for investors who want comparative yield from a high-yield product, but who are more sensitive to volatility and more focused on capital preservation.

Many investors assume that the pursuit of capital preservation and less volatility obtained through investing in higher rated high yield credit will result in lower returns over time. Certainly during periods of extremely hospitable credit environments, lower rated or lower quality credits would be anticipated to outperform the higher rated, less volatile issues. However, an investor would need the skill to actively sell the more speculative securities to avoid underlying default risk and rely on correctly timing their trade activity, as well as the suspect benevolence of increasingly absent high yield market makers. For those that realize the inherent challenges of skillfully trading the high yield asset class, comfort may be found by examining the long term return data by credit rating over the last thirty years. The below graph illustrates that higher quality issues (as represented by Ba rated issuers) have actually provided a compelling return opportunity relative to lower rated segments of the high yield market as well as the overall fixed income market (represented by the Barclays Aggregate Bond Index).



Barclays Index Performance – High Yield Comparison
Growth of 10,000 (1/1/84 – 3/31/16)

Key	Last Value
Ba U.S. High Yield – Index Value	194,483
U.S. Corporate High Yield – Index Value	155,511
B U.S. High Yield – Index Value	128,176
U.S. Aggregate – Index Value	102,765
Caa U.S. High Yield – Index Value	77,237

Source: Barclays Capital, Barclays Live – Time Series Plotter. Past performance does not guarantee future results.

Looking forward into 2016 and beyond, we remain optimistic regarding the long-term risk/return outlook for the higher-quality segment of the high yield market where the product is focused.

All indices are unmanaged and investors cannot invest directly in an index. Barclays is the source and owner of the Barclays Index data. Net of fees returns are calculated net of management fees and transaction costs and gross of custodian fees. As of 1/1/08, net returns were calculated by deducting the maximum applicable advisory fee for this strategy. Prior to this date, net of fees returns were calculated using actual annual client fees, pro-rated on a quarterly basis.