

Fallen Angels

From Sin to Win

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Fallen Angels: an expression going back to pre-Christian times, referring to angels expelled from heaven or having sinned¹

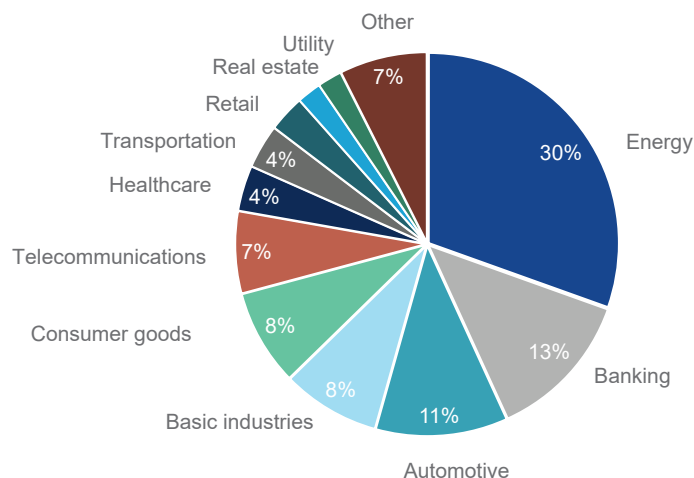
Fixed income investors have been roaming the yield-deprived earth looking for returns; many hoping that COVID-19 state spending would push up interest rates. With euro sovereign yields, basically, at where we left off at the end of 2019, and with the U.S. Treasury having given up more than 100 basis points, investors may be frustrated. High yield bonds, however, form a notable exception. With spreads having spiked by 2.75%² since the end of last year, it is an asset class worth considering for some. Whilst we acknowledge that it is not an asset class suitable for every investor; with central banks leading the way we believe that the emerging sub-category, “fallen angels” should be one to take seriously.

What are fallen angels?

Fallen angels are high yield corporate bonds, that at the time they were issued, were considered to be investment grade, but have since “sinned”, and therefore have been expelled from investment grade “heaven”; or rather in more financial terms, have been downgraded to sub-investment grade.

A broad array of sectors is represented in the asset class, the largest currently being Energy, Banking and Automotive (figure 1).

Figure 1 – Sector breakdown of ICE BofAML Global Fallen Angel High Yield Index



Source: ICE, VanEck analysis. Data as of 31/5/2020. The breakdown is based on market values

¹ Source: Mehdi Azaiez, Gabriel Said Reynolds, Tommaso Tesei, Hamza M. Zafer The Qur'an Seminar Commentary / Le Qur'an Seminar: A Collaborative Study of 50 Qur'anic Passages, cited in Wikipedia

² Source ICE, data as of 31/5/2020

Often, these bonds are issued by large corporations with well-known brand names, such as Ford, PemEx, Vodafone and Intesa Sanpaolo (figure 2).

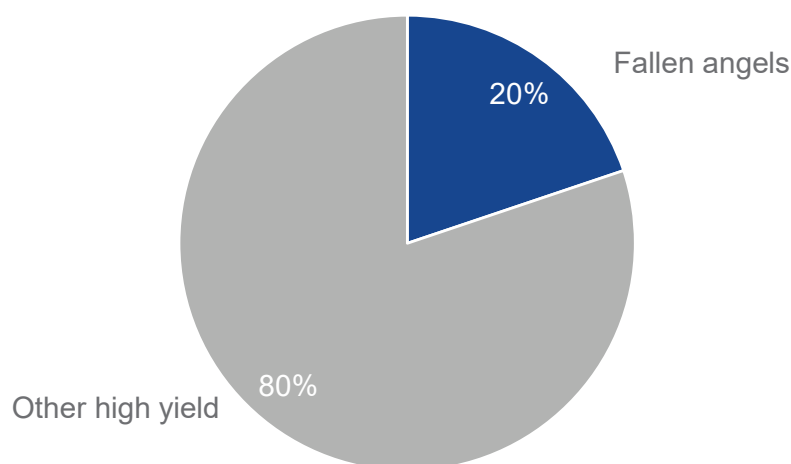
Figure 2 – Top 10 holdings of the VanEck Vectors™ Global Fallen Angel High Yield Bond UCITS ETF

Holding Name	Coupon	Maturity	Composite Rating	Currency	Country	% of Net Assets
PETROLEOS MEXICANOS	7.69	23 Jan 2050	BB+	USD	Mexico	1.98
FORD MOTOR CREDIT CO LLC	4.535	06 Mar 2025	BB+	GBP	United States	1.90
VODAFONE GROUP PLC	7	04 Apr 2079	BB+	USD	United Kingdom	1.69
PETROLEOS MEXICANOS	6.5	13 Mar 2027	BB+	USD	Mexico	1.56
AUTOSTRADA PER L'ITALIA SPA	5.875	09 Jun 2024	BB	EUR	Italy	1.50
INTESA SANPAOLO SPA	6.625	13 Sep 2023	BB+	EUR	Italy	1.50
UNICREDIT SPA	6.95	31 Oct 2022	BB+	EUR	Italy	1.45
PETROLEOS MEXICANOS	6.75	21 Sep 2047	BB+	USD	Mexico	1.36
TELECOM ITALIA FINANCE SA	7.75	24 Jan 2033	BB+	EUR	Italy	1.35
CASINO GUICHARD PERRACHON SA	5.976	26 May 2021	B-	EUR	France	1.30

Source: VanEck. Data as of 31/5/2020. These are not recommendations to buy or to sell any security. Securities and holdings may vary.

To date, the outstanding nominal value of fallen angels amounts to USD 440 billion, constituting circa 20% of the global high yield volume (figure 3).

Figure 3 – 20% of global high yield universe is made up of fallen angels



Source: ICE, VanEck analysis. Data as of 31/5/2020

What makes fallen angels special?

Historically, fallen angels have seen better risk adjusted returns than high yield bonds (figures 4 – 6).

Figure 4 – Fallen angels have outperformed regular high yield bonds in the past

Value of USD 100 initial investment



Past performance is not a reliable indicator for future performance, this also holds for historical market return.

Source: ICE, VanEck analysis. Data for the period 1/1/2005 - 30/4/2020. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index, high yield by the of ICE BofAML Global High Yield Index

Figure 5 – The outperformance holds for multiple time periods

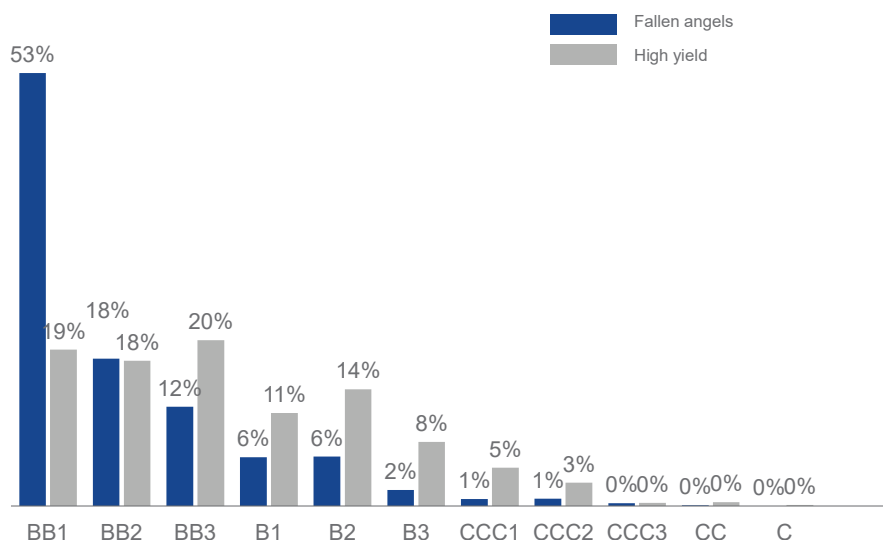
	1-year	3-year	5-year	10-year	10-year		
					Annualized return	Annualized standard deviation	Sharpe ratio
Fallen angels	-1,4%	3,0%	4,8%	7,2%	7,2%	9,0%	0,71
High yield	-5,3%	1,3%	3,1%	5,4%	5,4%	8,0%	0,57

Past performance is not a reliable indicator for future performance, this also holds for historical market returns.

Source: ICE, VanEck analysis. Data for the period 30/4/2010 to 30/04/2020. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index, high yield by the ICE BofAML Global High Yield Index. The Sharpe ratio is based on the risk free 1-month USD LIBOR rate.

Figure 6 – Credit quality of fallen angels compared to regular high yield bonds

Index composition (composite credit rating)



Source: ICE. Data as of 30/4/2020. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index, high yield by the ICE BofAML Global High Yield Index.

Breaking down a market anomaly

What can explain this historic outperformance? We see two reasons:

- Timing effect: The market tends to anticipate downgrades. Many IG [bond investors](#) sold out before, either because of their dislike for the deteriorated risk profile, or simply because their mandate does not allow them to hold sub-investment grade bonds. As the high yield investor universe is significantly smaller than the investment grade universe, the weak technical position leads to overselling. Because rating agencies often lag the market, downgrades have historically coincided with the trough of the bond's market price, on average. Once the actual downgrade has taken place, fallen angel investors step in, leading prices to revert to fair values.
- Historically, fallen angels have had lower default rates, roughly equal recovery rates and higher upgrade propensities than high yield bonds. A potential reason is that many fallen angels have defensive mechanisms, such as their brand (example: KraftHeinz), tangible assets (example: Macy's, which holds a sizeable real estate portfolio) or implicit state protection (example: Renault).

Figure 7 – Fallen angels have better default and rating evolution characteristics

	High yield	Fallen angels
Average Default Rate	3.3%	2.6%
Average Recovery Rate	41.1%	40.9%
Average Upgrade Propensity	3.4%	5.1%

Historical performance is not a reliable indicator for future performance.

Source: VanEck analysis, based on ICE data for the period 31/12/1999 to 30/4/2020. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index, high yield by the ICE BofAML Global High Yield Index.

These elements are also reflected in a return decomposition. As can be seen in figure 8, for most periods the price return of high yield bonds is negative. I.e., their market price drops while they are in the index; conversely, the price return of fallen angels is positive.

Figure 8 – Return decomposition of fallen angels versus regular high yield.

Cumulative Return (%) as of 31/5/2020										
	1-Year		3-Year		5-Year		10-Year		Since 31/12/2003	
	Price	Income	Price	Income	Price	Income	Price	Income	Price	Income
Fallen angel	0%	5%	-3%	17%	2%	32%	30%	105%	42%	276%
High yield	-5%	6%	-10%	18%	-10%	32%	-3%	94%	-10%	212%

Historical performance is not a reliable indicator for future performance, this also holds for historical market return.

Source: VanEck analysis, based on ICE data. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index, high yield by the ICE BofAML Global High Yield Index.

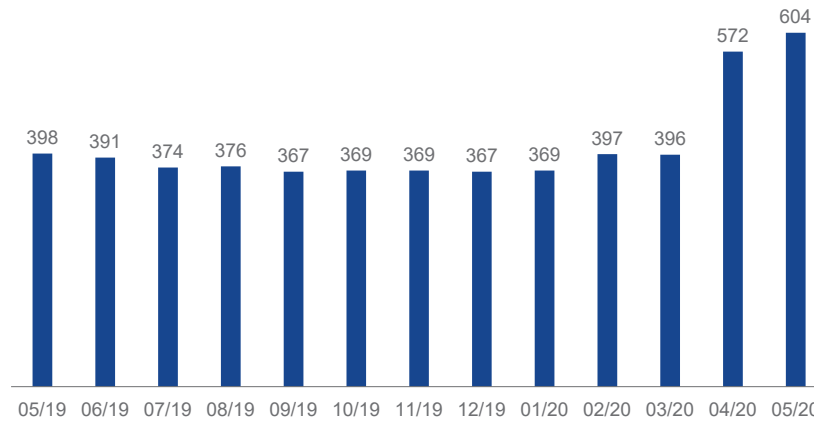
The current uniqueness of fallen angels

The current market climate has contributed to two factors that create a unique case for this asset class.

Firstly, the available universe just increased by 50% compared to a year ago, while both yields and spreads have seen a significant uptake (figures 9 and 10). For example, in the U.S. there exists a positive correlation between the number of new fallen angels in a given year and the absolute returns of the index, as well as the returns relative to high yield (figure 11). Historically, the best years have been the ones during or immediately following large waves of fallen angels.

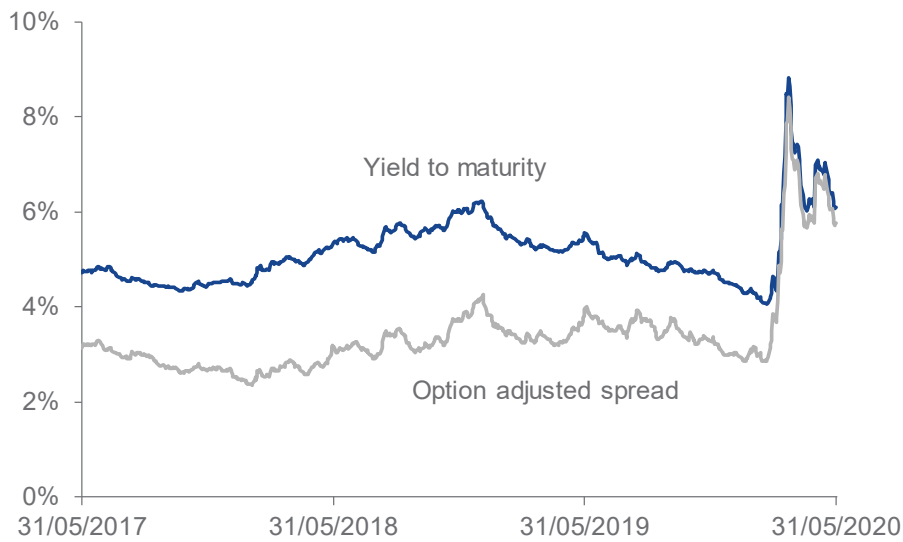
Figure 9 – The number of fallen angels has increased dramatically since the start of the COVID-19 crisis

Issues in the ICE BofA Global Fallen Angel High Yield Index



Source: ICE

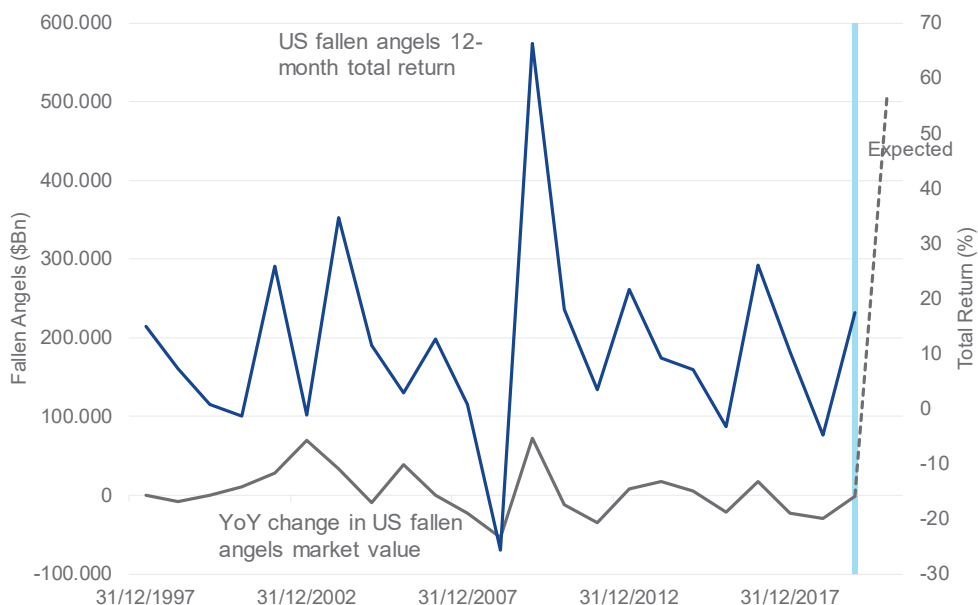
Figure 10 – Yields and spreads on fallen angels have spiked recently



Historical performance is not a reliable indicator for future performance, this also holds for historical market return.

Source: VanEck analysis, based on ICE data. Data as of 31/5/2020. Fallen angels are represented by the ICE BofAML Global Fallen Angel High Yield Index.

Figure 11 – U.S. fallen angel volume increase has corresponded with above average returns



Historical performance is not a reliable indicator for future performance, this also holds for historical market return.

Source: VanEck analysis, based on ICE data. Data as of 30/4/2020. U.S. fallen angels are represented by the ICE US Fallen Angel High Yield 10% Constrained Index

Secondly, the ECB announced it would extend its Pandemic Emergency Purchase Program (PEPP) with an additional EUR 600 billion, up from the already announced EUR 750 billion in March. As of this moment, bonds need to be investment grade in order to be eligible for the PEPP. In late April the ECB announced that fallen angels would also be eligible as collateral for banks to have access to the ECB's liquidity facility. As a result, market participants are expecting fallen angels to also become eligible for the PEPP. The U.S. Federal Reserve (Fed) is leading by example: in early May it announced that it would begin buying fallen angels as part of its Secondary Market Corporate Credit purchase program.

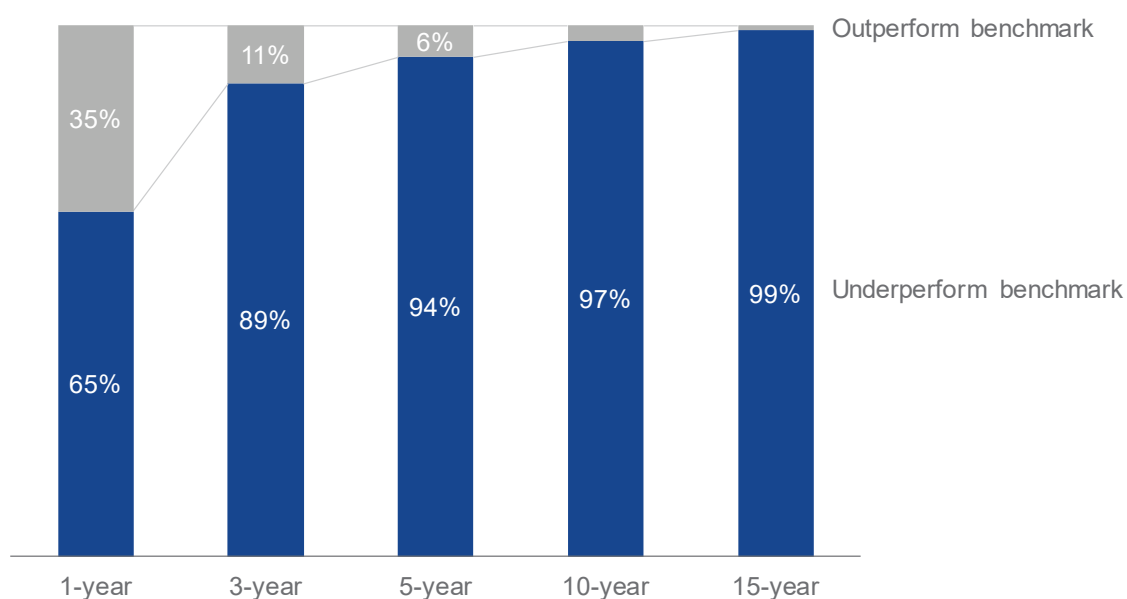
Central bank demand, combined with potentially improving economic forecasts, could provide further price support.

How to invest in this asset class?

Many investors may see high yield bonds as a natural candidate for an actively managed fund. However, SPIVA research shows that for the U.S., the majority of actively managed high yield bond funds have not outperformed their benchmarks (figure 12)³. As a result, a passive approach may be more suited.

Figure 12 – The majority of actively managed high yield funds underperforms its benchmark

U.S. actively managed high yield funds



Historical performance is not a reliable indicator for future performance.

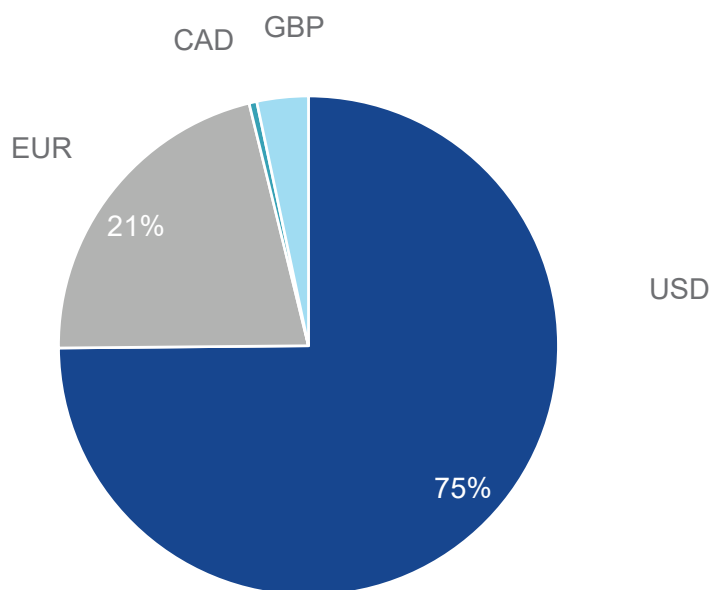
Source: SPIVA U.S. scorecard, year-end 2019. Data as of 31/12/2019

³ We use U.S. high yield bond funds as a proxy, because of data availability. In theory, the conclusion could be different for a global remit. However, we deem this unlikely, as 1) the U.S. is the largest region (37%) of the ICE BofAML Global Fallen Angel High Yield Index (as of 30/4/2020), 2) the underperformance of actively managed funds is very significant over longer time periods, 3) our own research of the largest global high yield funds indicates that most underperform over time

For our investors we propose the VanEck Vectors™ Global Fallen Angel High Yield Bond UCITS ETF. The global scope of the fund enables an investor to benefit from economic cycle [diversification](#), a larger number of potential issuers and currency diversification (figure 13).

Figure 13 - Global fallen angels benefit from currency diversification

Currency decomposition of the ICE BofA Global Fallen Angel High Yield Index, based on market values



Source: VanEck analysis, data as of 30/4/2020

Most sin, even angels; therefore, by investing in them as they fall back to earth, one may benefit when they spread their wings and fly back up to the sky.

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