High-Yield Securities Disclosure

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Investing in high-yield securities can be complex and involves a variety of risks and benefits. As such, we strongly encourage you to review this disclosure as it highlights important factors to consider before investing in high-yield securities. For further assistance in understanding or determining whether high-yield securities are a suitable addition to your financial portfolio, please contact your financial professional.

Definition

High-yield securities are securities rated below investment grade by one of the established credit rating agencies—i.e., below Baa-3 by Moody's Investors Service or below BBB- by Standard & Poor's Ratings Services. Also referred to as junk, speculative, high opportunity, non- or sub-investment grade, high-yield securities are issued by organizations that are perceived to have a greater risk of defaulting on interest or principal payments and therefore do not qualify for investment grade ratings. High-yield securities exist in both the taxable and municipal asset classes.

Issuers could be highly leveraged companies or municipal entities, those experiencing financial difficulties, emerging companies looking to offset unproven operating histories or small companies with financial plans deemed speculative or risky. Such issuers, typically, have to pay higher interest rates to attract investors to buy their securities and to compensate those investors for the risks associated with investing in an entity of lower credit quality. Issuers of high-yield security; include many different types of U.S. corporations, certain U.S. banks (excluding CDs), various foreign governments, some foreign corporations and various municipalities and their related entities.

The high-yield market includes both originally-issued high-yield securities and outstanding securities of former investment grade guarantors that were downgraded since issuance. The volume of new issues varies depending on economic and market conditions expanding during periods of economic growth when investors' appetite for risk often increases, and waning in recessions or market environments when investors are more cautious. Similarly, the high-yield market can expand when large or numerous issuers are downgraded to high-yield status or shrink when there are upgrades from speculative to investment grade.

Credit ratings

Securities of any kind are not required to have credit ratings. Issuers and underwriters pay credit rating agencies a fee to rate both their financial performance as well as the likelihood that the issuer will be able to meet future debt obligations. Security ratings are, therefore, an assessment of an issuer's ability to repay its debt in a timely manner, based on its history of borrowing, repayment and other factors. The credit rating influences the rate at which an issuer must compensate an investor for the risk involved in lending money to their company or municipality. Therefore, a change in an issuer's credit quality after issuance affects the secondary market price and yield of its bonds, most commonly with non-U.S. government guarantors such as corporate and municipal issuers.

Rating agencies use quantitative tools and qualitative judgments to evaluate the creditworthiness of an issuer and have developed various grading systems from which they assign credit ratings to these issuers. Typically, only securities issued by the largest and strongest companies and local governments qualify for investment-grade ratings, which indicate strong relative credit strength. The highest quality rating is triple-A. The rating levels descend to triple-C as the possibility of default increases, and finally to D, or default. While credit ratings define the high-yield market and many investors rely on these ratings in their portfolio guidelines, it is important to note that ratings are a current assessment of an issuer's creditworthiness and do not guarantee future performance.

Non-rated

Non-rated securities are fixed income securities guaranteed by issuers that do not have a current rating from one or more of the major credit rating agencies. It could be that the security came to the market originally without soliciting a rating, or that the issuer has not supplied sufficient updated information since issuance for the particular original rating agency to maintain surveillance and continue to publish updated ratings. Non-rated securities are not necessarily low quality, given the reasons above, but they cannot be deemed to be investment grade either as that designation requires a current rating. Issuers generally have two main reasons for issuing non-rated securities. First, some issuers are considered creditworthy borrowers in the marketplace based on other outstanding issues and ratings, and the rating for a particular issue is foregone because the size or placement of the issue is such that the cost of being reviewed and rated outweighs the benefit. A non-rated security will generally offer a yield higher than a comparably rated security, so if the analysis is that the cost of obtaining a rating exceeds the differential in interest liability for borrowing, an issuer may opt for issuing non-rated securities. Second, an issuer may feel that their securities would not meet the criteria of the rating agencies and would be classified as below investment grade, and thus opt to come to market with a non-rated designation.

In the municipal bond marketplace, many non-rated bonds are revenue bonds rather than general obligation bonds. Revenue bonds are backed by the income stream of the project which the bonds finance, rather than the full faith and taxing power of a local municipality. Understanding the project and the revenue stream associated with the backing of the bonds are key factors in understanding the credit risk associated with the bonds. An investor should always review the official statement, specifically those sections that cover the description of the project, the use of bond proceeds and the risks associated with the issue before investing. For securities in the secondary market, a review and understanding of the most recent financial disclosures is also important.

Credit risk	Moody's	Standard & Poor's
Investment Grade		
Highest quality	Aaa	AAA
High quality	Aa1, Aa2, Aa3	AA+, AA, AA-
Upper medium grade	A1, A2, A3	A+, A, A-
Medium grade	Baa1, Baa2, Baa3	BBB+, BBB, BBB-
Below investment grade		
Lower medium grade	Ba1, Ba2, Ba3	BB+, BB, BB-
Low grade	B1, B2, B3	B+, B, B-
Poor quality	Caa1, Caa2, Caa3	CCC+, CCC, CCC-
Most speculative	Ca	CC
No interest being paid or bankruptcy petition filed	C	C
In default	D	D

Benefits

High-yield securities may offer investors a number of potential benefits, some of which are:

Enhanced income

Investors tend to invest in high-yield securities because the yields on these security instruments are generally higher than yields available in investment-grade fixed income securities. The yield spread between high-yield securities and investment-grade securities has generally been between two and four percentage points, depending on the issuer and market conditions. However, market conditions and higher volatility at any point in time can cause spreads to expand dramatically outside this typical range. These higher yields come with an increased risk of non-payment and default. Consequently investors should be cautious. High-yield securities should comprise only a portion of an investor's portfolio.

Capital appreciation

High-yield securities can experience dramatic price fluctuations depending on market conditions and issuer developments. Positive events in the economy, industry or issuing entity can reward investors with increases in a high-yield security's market price, otherwise known as capital appreciation. These events include rating upgrades, improved earnings reports, mergers or acquisitions, positive product developments, local developments or market-related events.

Security

In the taxable sectors, bondholders usually have priority over stockholders in a company's capital structure and are more likely to receive payment during liquidation or bankruptcy. For all fixed income investors, both taxable and municipal, the percentage of this payment compared with the original investment is called the "recovery rate." Holders of secured debt and unsecured senior debt have the highest claim on assets in a bankruptcy distribution. However, even the holder of a low-rated bond is entitled to a share of a failing issuer's assets ahead of preferred or common stockholders.

Diversification

High-yield securities are often considered a separate asset class, involving different characteristics from those of other securities. High-yield securities can help investors spread assets across different segments of the financial markets, thus potentially reducing risk concentration in any one asset class. While diversification does not insure against loss, it may help decrease overall portfolio risk and improve the consistency of returns.

Interest rate volatility

Security prices are inversely related to interest rates—when interest rates move up, security prices fall and vice versa. The longer a security's maturity, the more vulnerable its price is to interest rate fluctuations. High-yield securities can be, however, less sensitive to interest rate changes because they tend to have shorter maturities. They are typically issued with terms of 10 years or less, and are callable after four or five years.

Risks

Depending on an investor's risk tolerance, there may be a place in their investment strategy for high-yield securities —but they are not suitable for all investors and should be used in moderation as support for, but not the core of, a well-diversified fixed income portfolio. In addition to a tolerance for risk, investors in high-yield securities must also have the patience to weather periodic market downturns or unexpected events that negatively impact individual issues. Credit risk and interest rate risk are the two main concerns for investors.

Credit risk

Credit risk is the risk associated with a bond issuer's ability to make timely principal and interest payments to its creditors. For investors in high-yield securities, credit risks can involve:

Default risk — Defaults occur when an issuer fails to pay an interest or principal payment to debt holders as scheduled and specified in the original indenture. Issuers are prohibited from making any payments to preferred or common shareholders if they are in default. Securities may carry a low credit rating as a result of the issuer's financial health or their placement in the issuer's capital structure. In the event of bankruptcy or dissolution, securities that rank lower in the capital structure have a weaker claim and are frequently left with minimal, or possibly, without any recovery. A typical capital structure will have, in descending order of claim priority; secured debt, unsecured debt, preferred securities and finally common stock. Non-exchange listed preferred stockholders, a subset of preferred, is low in the priority of claims, but higher than common stockholders, which is lowest in priority. When an issuer is in default, lower ranked securities tend to trade at large discounts to their par value and are often very illiquid. Prices are typically volatile and the securities may be difficult, if not impossible, to sell.

Downgrade risk — Downgrades result when rating agencies lower their ratings on outstanding bonds. A company or municipality's rating could be downgraded from BBB to BB if the rating agency believes the issuer has become less able to meet its debt obligations. Downgrades are usually accompanied by declines in market prices for the downgraded security. In some cases, the market anticipates downgrades and bids down prices prior to the official rating agency announcement. Before bonds are downgraded, agencies may place them on a "credit watch" list (which means that the issue is being reviewed for possible re-rating), which also tends to affect prices negatively.

Event risk — There are a variety of pitfalls that can affect an entity's ability to repay its debt obligations on time. These include, but are not limited to, poor management, changes in management, failure to anticipate shifts in corporate markets or municipal demographics, rising costs of raw materials or labor, regulations and new competition.

Interest rate risk

Interest rate risk, a component of market risk, is the risk that rising interest rates will cause a security's price to fall and therefore decrease the value of an investment. How much a security's price will move for any particular change in interest rates will depend on many factors such as time to maturity, coupon or interest rate, supply and demand and other market-relevant considerations. Securities that have longer maturities or lower coupon rates will have a greater percentage change in their prices than shorter maturity or higher coupon bonds in the same interest rate shift. Securities that have shorter maturities and higher coupon rates tend to have more price stability. Within interest rate risk, there are certain sub-groups:

Marketability (liquidity) risk — the risk that a security will be difficult to liquidate in the marketplace, which affects some classes of bonds more than others.

Call risk — the risk that an issuer may redeem a security earlier than its original maturity based on provisions established in the original indenture. This risk is more relevant during periods of declining interest rates.

Purchasing power risk — the risk that inflation will lower the relative value of a bond's principal and interest payments.

Reinvestment risk — the risk that, as interest payments are received for a bond, interest rates are lower and the proceeds must be reinvested at those lower rates.

Managing risk

Due to the increased risks associated with high-yield securities, it is important that investors consider utilizing some of the following techniques to mitigate potential risks:

Diversify across issuers, industries and geographies — Investors should not put all their assets into one issuer's security or asset class, whether investment grade or speculative. Spreading money among several issuers can help reduce the risk of price declines or defaults caused by industry- or geographic-specific situations or circumstances.

Adjust portfolios over economic and market cycles — Potentially seek to sell securities from an industry or town facing economic downturn and purchase securities guaranteed by issuers with a more positive outlook.

Monitor credit ratings and research — Investors should follow news alerts from the rating services to determine whether a security has been downgraded or is on a "credit watch" list. In addition, investors should monitor published research and credit analysis for individual issuers in their portfolios. Know what you own.

Follow company and industry news — Investors should watch industries and local governments closely, just as they would monitor equities, to help anticipate factors that may affect the credit rating or price of a bond.

Conclusion

From enhancing return to improving diversification, high-yield securities can provide potential benefits to investors who understand and can accept the accompanying risks. This document is to serve as a guide to some of the factors that should be weighed and considered by investors prior to investing in high-yield securities, as well as over the holding period for those same securities. For further assistance in understanding high-yield securities or placing orders, please contact your financial professional.

For additional information, visit the following websites:

- Financial Industry Regulatory Authority: www.finra.org
- U.S. Securities and Exchange Commission: www.sec.gov
- Securities Industry and Financial Markets Association: www.investinginbonds.com