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Yield – the hunt continues

The financial market's sirens have been singing about yield. In a world of zero interest rates engineered by central bankers, it was inevitable that many investors would listen. But following the music has suddenly brought them perilously close to the rocks.

Investors searching for income sent junk bond yields to new lows close to 6 per cent in September. Bankers took advantage of investors' demand for yield, bringing increasingly speculative companies and debt structures to market – a classic sign of froth. But investors' preference, for now, appears to be shifting away from yield towards safety, as worries about higher tax rates and an uncertain US economy come to the fore.

Outflows from junk bond funds topped $1bn in the week to Wednesday, Lipper reports. Also on that day, investors withdrew $220m from the iShares iBoxx High-Yield exchange traded fund, its biggest daily outflow ever. Investors may well stay away at least until the fiscal cliff is averted – if it is.

Closed-end funds are another area that had benefited from the hunt for yield. Many of these use leverage, which boosts returns but makes them more volatile. Perhaps the starkest case of income desperation is the Pimco High-Income fund, which focuses on sub-investment grade corporate debt. It traded at a premium to the value of the bonds in the fund of as much as 70 per cent in early October, according to CEFConnect. This week its shares dropped 9 per cent, but still trade at a 30 per cent premium.

This is good news for investors who have stayed away from yield plays so far. UBS says 39 of the 103 closed-end funds it tracks are trading at premiums, compared with 71 in October. If the current trend continues, some juicy discounts may be available. Now that would be a siren song worth listening to.

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