Yield Over Spreads: Rethinking Leveraged Credit Investing

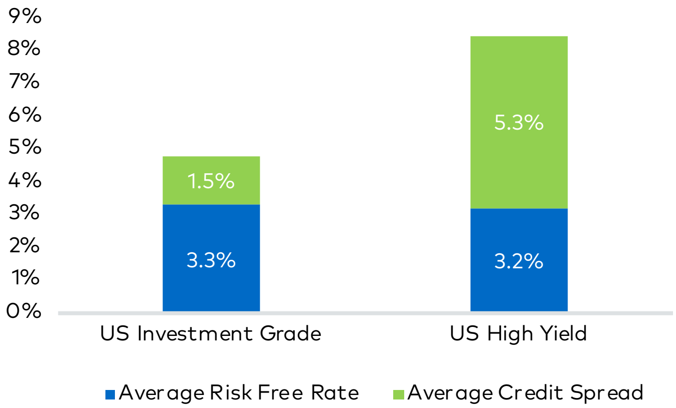
With starting yields at multiyear highs, leveraged credit—which includes high yield bonds and leveraged loans—offers investors the potential for attractive long-term returns, regardless of where spreads move next. While many investors believe the best time to invest in leveraged credit is when credit spreads are wide, decades of historical analysis tell a different story. The most consistent and reliable predictor of future returns has not been the timing of spreads, but the yield available at the time of investment.

Spreads vs. Yield: What Really Drives Leveraged Credit Returns?

When investing in credit-risky instruments, investors tend to focus almost exclusively on credit spreads to determine whether they are being adequately compensated for taking on credit risk. Credit spreads help determine if the additional yield adequately compensates investors for taking on greater risk compared to safer investments like cash or developed-market government bonds. For leveraged credit investors, this focus on credit spreads makes perfect sense. Credit spreads drive a significant part of the return when compared to investment grade securities.

This dynamic is illustrated in Figure 1 below, which shows the effective yield[1] of the Bank of America Merrill Lynch US investment grade[2] and high yield bond[3] indices from December 1996 to March 2025. This figure breaks down yield into two components: the risk-free rate (represented by US government bonds) and the credit spread. Unlike investment grade corporate bonds—where risk-free[4] rates have historically accounted for most of the average yield—a far greater proportion of the historical average yield in high yield bonds has come from sub-investment grade credit spreads.

Figure 1. Decomposing Historical Average Yields: US Investment Grade and High Yield Indices (1996–2025)



As of 04-15-2025. Source: ICE, ICE BofA US Corporate Index, ICE BofA US High Yield Index.

1 Effective yield is a measure of the actual annual return earned on a bond, loan, or other fixed-income security, taking into account the effects of compounding interest over a specified period (usually one year). It differs from the simple, or nominal, yield because it incorporates how often interest is paid and reinvested.

2 ICE BofA US Corporate Index Effective Yield, which is maintained by ICE Data Indices, LLC, tracks the yield-to-maturity (YTM) of the broad US dollar-denominated investment grade corporate bond market, as represented by the ICE BofA US Corporate Index.

3 The ICE BofA US High Yield Index, which is maintained by ICE Data Indices, LLC, is market capitalization weighted and comprises U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

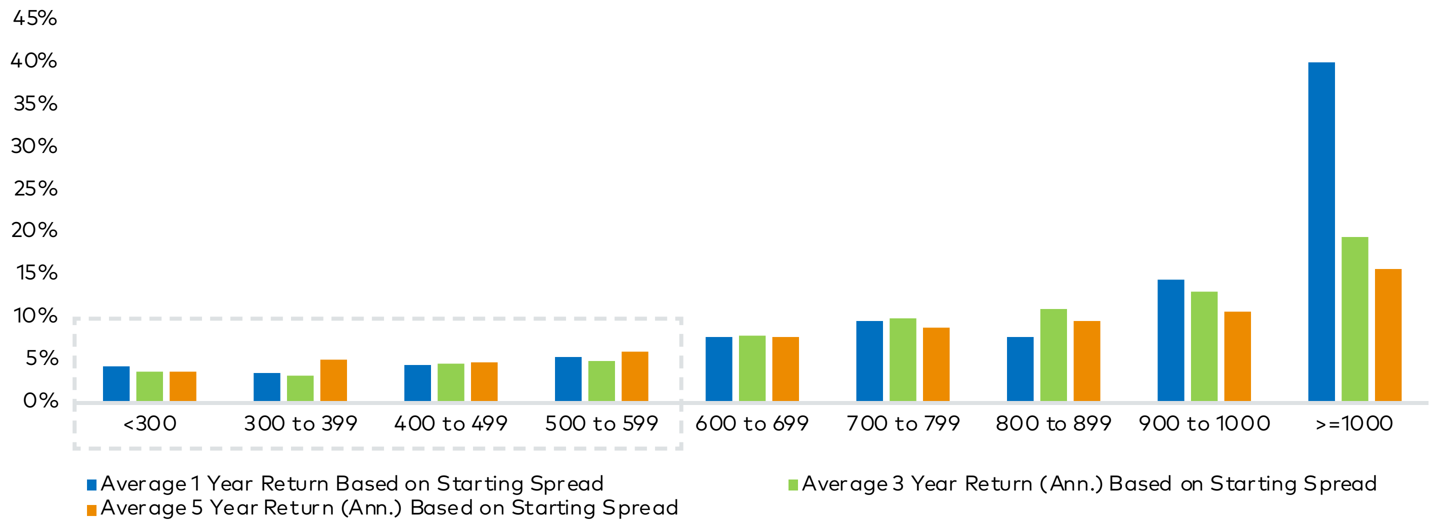
4 The higher risk-free rate component in investment grade bonds primarily reflects their longer average maturity relative to US high yield bonds, as longer maturities generally require additional yield compensation.

While this underscores the importance of spreads, the historical data reveals an interesting nuance. When we examine the relationship between starting credit spreads and subsequent total returns for high yield bonds—a relationship illustrated in Figure 2 below—we observe an interesting pattern. Specifically, when investors buy high yield bonds at credit spread levels below 600 basis points per annum, the resulting returns tend to be quite similar, regardless of the holding period. For reference, the historical average credit spread during this period has been about 530 basis points.

High Yields, High Potential: Why Entry Yield Matters

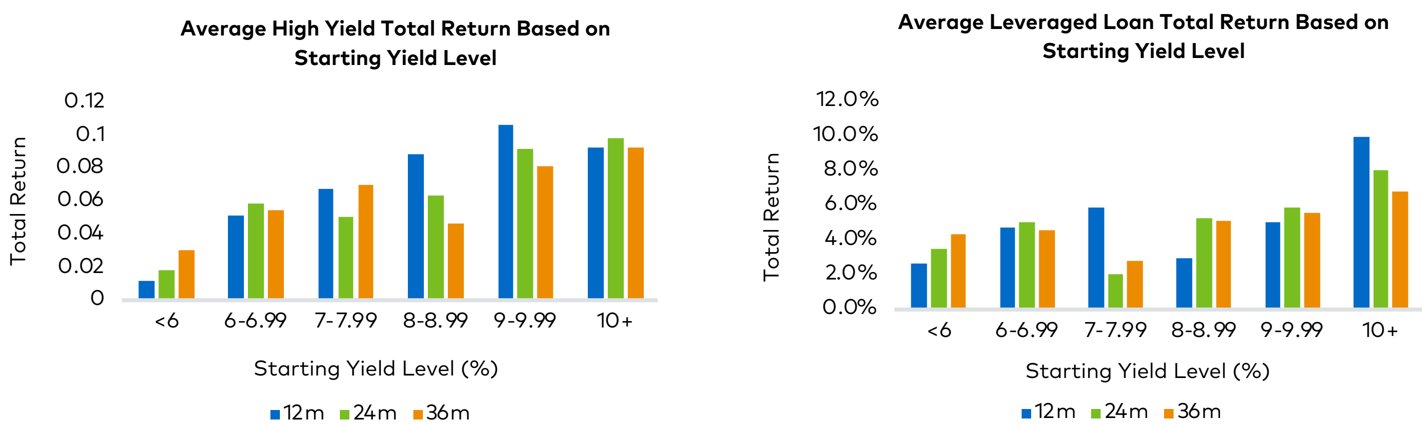
When viewed through the lens of total yield, a clear pattern emerges. Historically, higher starting yields have been associated with stronger future returns across most holding periods for both high yield bonds and leveraged loans. As illustrated in Figure 3, entering at a higher yield level has typically resulted in more favorable subsequent returns.

Figure 2. Average 1-, 3-, and 5-Year Returns by Starting Credit Spread US High Yield Bonds (from Dec 31, 1996)



As of 04-15-2025. Source: ICE, ICE BofA US High Yield Index. **Past performance does not guarantee future results.**

Figure 3. Total Returns by Starting Yield: US High Yield Bonds & Leveraged Loans



As of 3-31-2025. Returns are calculated using monthly data for the ICE BofA US High Yield Index and the S&P UBS Leveraged Loan Index and are annualized for periods greater than 1 year. The 12m, 24m, and 36m represent the holding periods necessary to achieve the average annualized returns depicted in the figures. Time period is 12/31/1996 through 03/31/2025 for both figures. **Past performance is no guarantee of future results.**

Figures 4 and 5 show, for each month since December 31, 1996, the yield on US high yield bonds—including the breakdown between the risk-free rate and credit spread—alongside the subsequent 1-year annualized return an investor would have received if they invested in the US high yield market at that point in time. The figures also show that investing during periods of elevated yields—typically following major market dislocations—has historically led to some of the strongest subsequent returns. Notable examples include recoveries after the tech crash (August 2001), the Global Financial Crisis (October 2008), the oil price downturn (February 2016), and the Covid-19 selloff (April 2020).

Conversely, as highlighted in the orange areas in Figure 5, when overall yields were low, returns were generally modest or, in some cases, slightly negative.

Figure 4. Effective Yield, Risk Free Rate, and Credit Spread with 1-Year Annualized Returns

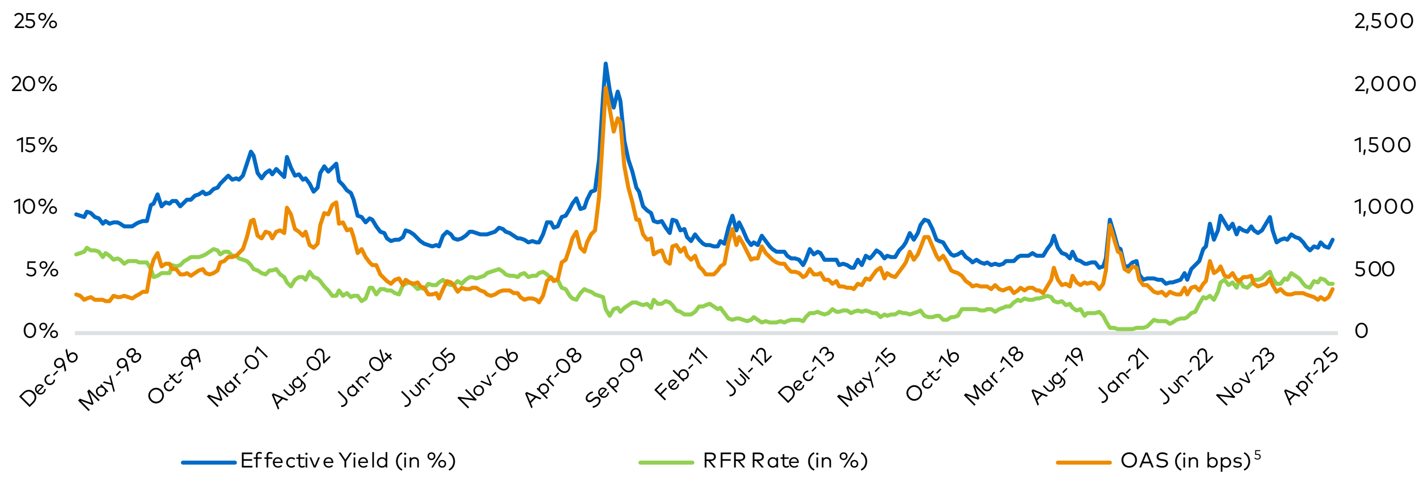
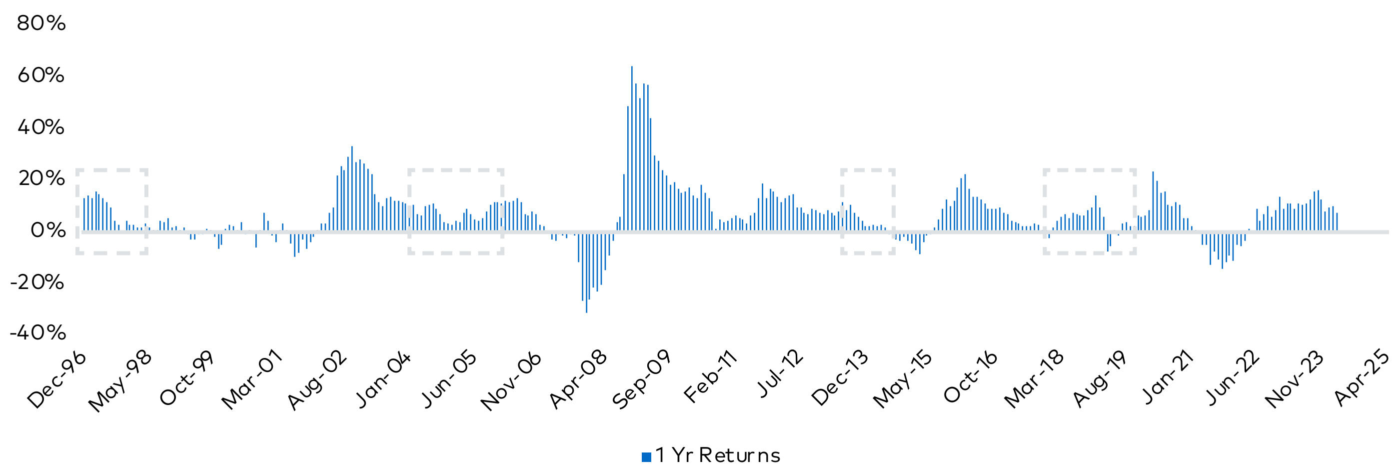


Figure 5. 1-Year Annualized Returns: Impact of Low-Yield Entry Points



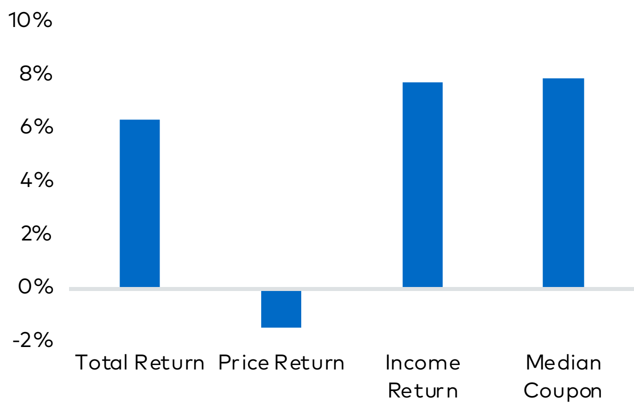
As of 03-31-2025. Source: ICE, ICE BofA US High Yield Index. Returns are based on monthly data for the ICE BofA US High Yield Index. The figures illustrate the 12-month holding periods required to achieve the average annualized returns. The analysis covers the period from 12/31/1996 to 03/31/2025 for both figures. **Past performance is no guarantee of future performance.**

5 Option-Adjusted Spread is the yield spread that a fixed-income security offers over a comparable risk-free benchmark yield curve (such as US Treasuries). OAS represents the compensation that investors receive, in addition to risk-free rates, for assuming credit, liquidity, and optionality risks.

Figure 6 shows that from 1994 to 2025, over 75% of total returns in the US High Yield index have come from income—specifically, coupon payments—rather than capital gains or spread tightening. This highlights that, for high yield investors, the primary source of return has been the income generated, not changes in credit spreads or market prices.

Figure 6. The Coupon Drives Attractive Returns

Annualized Returns: December 1996–March 2025



As of 03-31-2025. Source: ICE, ICE BofA US High Yield Index.

As of April 21, 2025, the credit spread on U.S. high yield bonds—measured by the ICE BofA U.S. High Yield Index—was approximately 416 basis points per annum. Historically, as shown in Figure 2, credit spreads at this level have been associated with below-average annualized returns.

However, the effective yield on April 21, 2025, was 8.1%—well within the average range over the past 28 years. If historical patterns persist, this level of yield has typically led to attractive returns, often exceeding the mid-single-digit range.

Conclusion

Decades of historical evidence reveal a clear takeaway for high yield investors: starting yield has been the most significant driver of long-term returns. While wide credit spreads often attract attention, it is the absolute level of yield at the time of investment that has proven a far more reliable indicator of future performance. Over time, income generated from the initial yield has contributed more to total returns than gains from spread tightening.

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