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Despite a recent (and remarkable) resurgence in the popularity of investing in common stocks, bonds seem to continue to retain their appeal with investors – and no area of the bond market more so than "corporate" or "high yield" bonds.

I recently came across an advertisement for the Mackenzie Sentinel Corporate Bond Fund – a fund I own personally and hold in many clients' portfolios.

Now, a quick primer on mutual fund advertising: Fund companies must publish a fund's full track-record in advertisements – they can't "cherry pick" a great year or two. And it must be made very clear that "Past Results are NO Guarantee of Future Performance". Still, there's nothing saying a fund company must display data for all their fund mandates in their advertising. They are perfectly allowed (and I don't blame them) to advertise only those funds that have done especially well recently.

And that's certainly the case with high-yield bond funds. They've done wonderfully the past few years. The Mackenzie fund was ahead over 12% in 2012 and has a 3-year return to the end of 2012 of 9.65% compounded annually (the fund doesn't have a 5-year record).

Of course, that's not the $64,000 issue for investors. The real issue is whether this fund (or type of fund) is still appropriate for portfolios and, if it is, what would be a reasonable expectation of performance?

High-yield bond funds are "high-yield" because they primarily hold non-investment grade bonds – bonds below a "BBB" rating. They have high yields because they are higher risk. The average Yield-to-Maturity (YTM) of bonds in the Mackenzie portfolio was 5.68% at time of writing. I would expect a BBB-rated bond with a similar duration to currently yield 2% to 2.5%.

So how does a 5.68% YTM become a 12%+ return? 1) declining interest rates (which lift the value of all bonds) 2) improving credit scores of the bond issuers (which generally means improving equity markets). This, again, lifts bond values and 3) few defaults - which generally stay low as economic conditions (i.e. markets) improve.

So, return expectations going forward? It's hard to imagine interest rates declining further. And much of the improvement in company credit scores has likely already happened. That gives us 5.68%. Now, what about defaults? No hard-and-fast rules, but a reasonable default rate might be 3% of the portfolio. If there was a 50% "recovery rate" on those defaults, that means a 1.5% net LOSS for the fund – so now a reasonable net return expectation might be 4.18%. That's still well above the return on investment-grade bonds – but a long way from 12%!!

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