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Insight INVESTMENT

August 2021

CATCH A RISING STAR
FALLEN ANGELS MAY HOLD THE KEY

'RISING STARS' PRESENT POTENTIAL OPPORTUNITY AS THE ECONOMY RECOVERS. INVESTING IN A PORTFOLIO OF FALLEN ANGELS MAY BE AN EFFICIENT WAY TO CAPTURE FUTURE RISING STARS.

EXECUTIVE SUMMARY

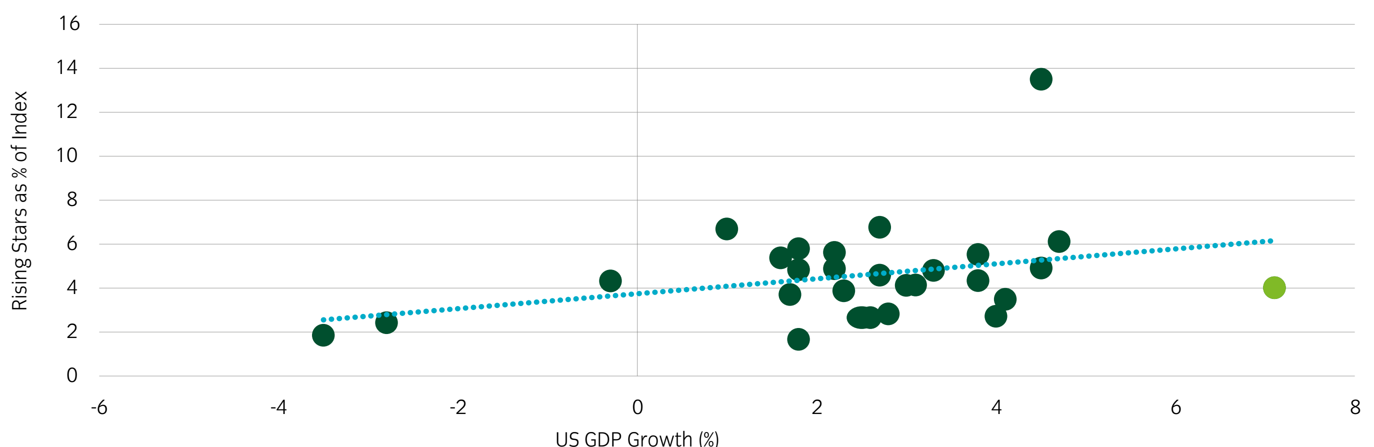
- The economic recovery could be a breeding ground for 'rising stars' – the term for companies that get upgraded from high yield (HY) to investment grade (IG).
- Historically, rising stars are almost twice as likely to come from the fallen angel market than the broader HY market.
- A dedicated fallen angels strategy may offer the most efficient path for capturing rising stars, while offering historically equity-like returns for bond-like volatility.

RISING STARS SET FOR LAUNCH?

A recovering economy is potentially a breeding ground for rising stars

Companies are more likely to upgraded during periods of economic growth and recovery, as rising revenues feed into stronger balance sheet metrics (Figure 1).

Figure 1: A rising tide potentially launches rising stars[1]



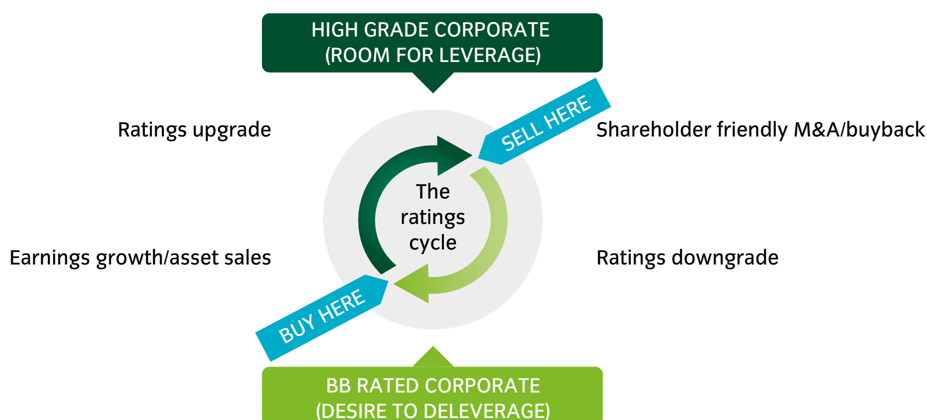
As the US economy recovers, it is progressing into the 'mid cycle' phase of the expansion, driven by consumer spending and public and private investment. We anticipate ~$100bn of rising stars to emerge from the high yield market now until the end of 2022, up from $20bn in H1 2021 and $20bn in 2020.

[1] Bloomberg, Barclays, July 2021

The 'ratings cycle' may also encourage upgrades

Many fallen angels are incentivised to return to IG status (Figure 2).

Figure 2: The 'ratings cycle' describes why many fallen angels are more likely to become rising stars[2]



Many fallen angels were downgraded 'voluntarily' by engaging in equity-friendly behavior (such as a share buybacks or M&A), resulting in higher leverage. Once downgraded, equity-friendly activity is more aligned with bondholders – such as growing into more creditworthy entities or voluntarily reducing leverage to enjoy significantly lower interest costs. For example, consider Kraft Heinz, the food giant which was created in an equity-friendly mega-merger in 2015. The deal left the resulting entity highly leveraged with $30bn in outstanding debt. Ultimately, it was downgraded from investment grade to fallen angel status in 2020. Since then, the company has notably pivoted its strategy, recently announcing bond buybacks and selling Planters, Corn Nuts and other businesses for $3.4bn to reduce debt, likely in effort to reclaim its investment grade status[3].

THREE STAGES OF RISING STAR OUTPERFORMANCE

A rising star's outperformance tends to occur in multiple stages as ratings agencies can lag market pricing.

Stage 1: Journey begins

Up to three years or more before an upgrade, a future rising star begins deleveraging. Bottom-up investors take note, resulting in narrower spreads. Eventually, over this time period, the issuer becomes a clear candidate for an upgrade and spreads outperform versus peers.

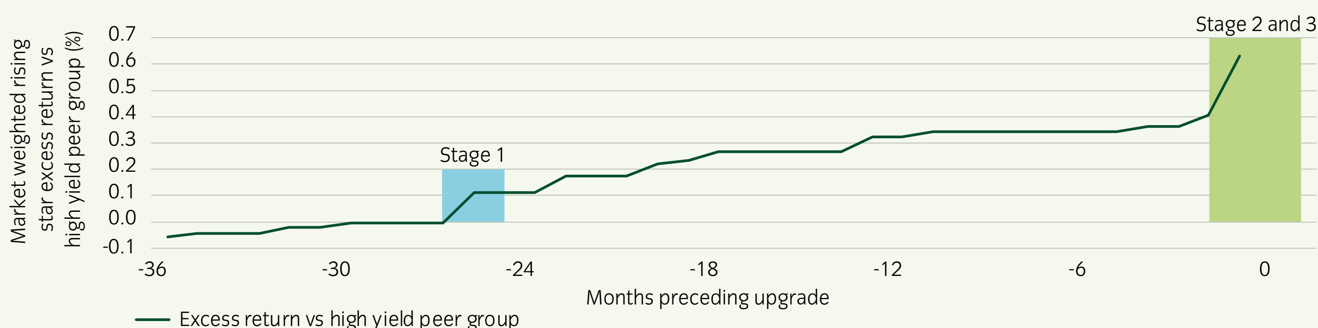
Stage 2: Upgrade announced

The rating agencies announce the upgrade, the market reacts positively and spreads tighten in anticipation of future buying from a larger IG asset base.

Stage 3: 'Forced' buying

Once upgraded, at month end, passive strategies and ETFs will rebalance their portfolios and become forced buyers to minimise tracking error. In anticipation of this buying activity, volumes pick up in these names and spreads tighten further.

Figure 3: The stages of rising star performance[4]



[2] For illustrative purposes only. [3] The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed. [4] Bloomberg, August 2021.

CHALLENGES WITH TRADITIONAL APPROACHES

There are three key challenges to traditional concentrated approaches:

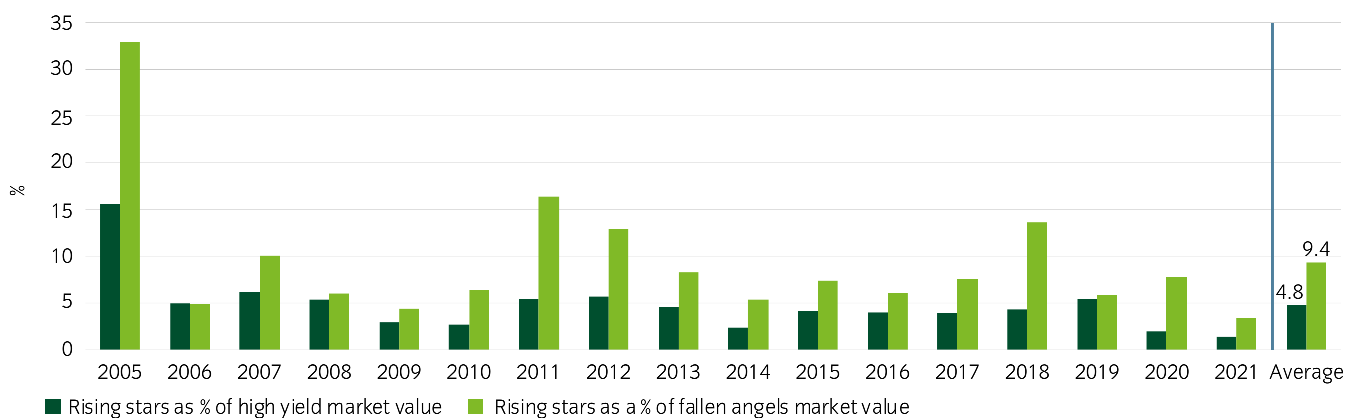
1) **Concentration risks:** The pool of potential rising stars has historically been ~5% of the broader HY market on average. Traditional approaches to specifically targeting just this opportunity set means high concentration risks, and thus a high impact from volatility
2) **Timing challenges:** Pin-pointing early-stage rising stars can be tricky, and the penalty for getting it wrong can be severe. Rating agencies each have specific methodologies and two agencies typically need to upgrade a bond before passive accounts start buying them.
3) **High transaction costs:** The HY market offers relatively low two-way liquidity in single bonds, particularly within smaller issuers (which could be early-stage rising star candidates). High transaction costs would potentially limit active trading.

'FALLEN ANGELS' COULD HOLD THE KEY TO CAPTURING RISING STARS

In our view, a diversified 'fallen angels' portfolio could be a compelling way to catch rising stars early and reliably.

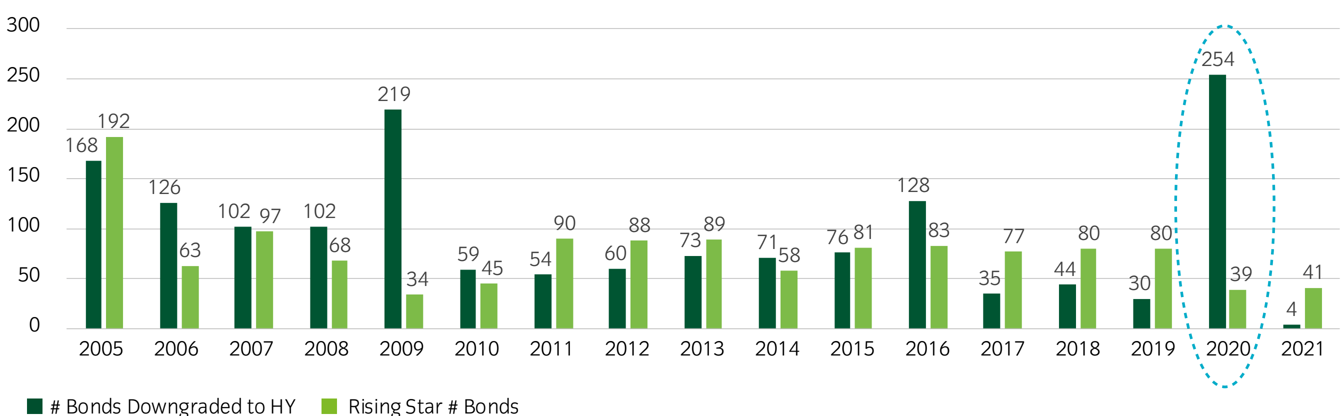
Historically, rising stars are almost twice as likely to come from the fallen angel market than the broader HY market (Figure 4).

Figure 4: Rising stars make up a higher proportion of the fallen angels market than HY[5]



Over 250 US bonds became fallen angels during 2020, increasing the pool of upgrade candidates (Figure 5).

Figure 5: A spike in fallen angels in 2020 has increased the pool of rising star candidates[6]

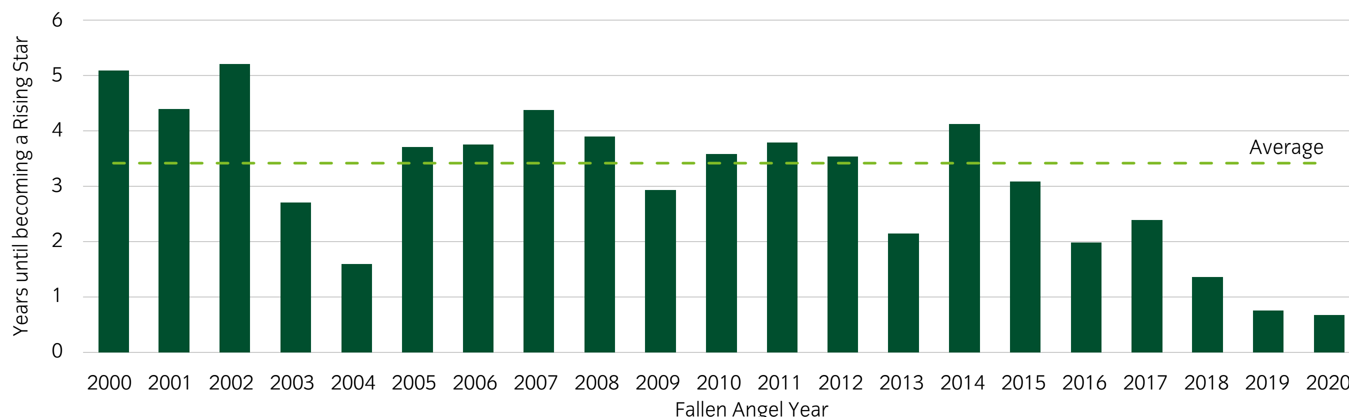


[5] Bloomberg, August 2021.
[6] Bloomberg, June 2021.

Barclays estimates that 30% of 2020's fallen angels will rebound to rising star status[7] and JP Morgan expects $297bn in total rising star upgrades[8]. In 2021 so far, names such as Cenovus Energy, Nordstrom, MTNA and ArcelorMittal have even already returned to IG-status this year having been 2020 fallen angels[9] .

Fallen angels have also been upgraded at an accelerating pace in recent years, indicating that now is potentially an ideal time to consider a fallen angels strategy.

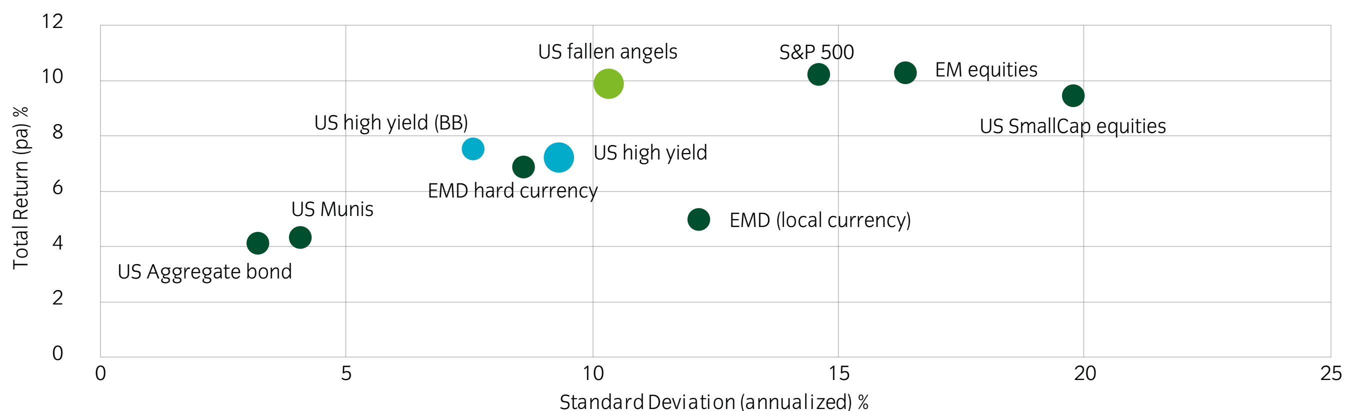
Figure 6: Former fallen angels have been returning to IG at an improving pace[10]



FALLEN ANGEL STRATEGIES MAY ALSO OFFER ADDITIONAL TAILWINDS

Fallen angels have historically delivered returns in line with equity markets despite volatility in line with bond markets (Figure 7).

Figure 7: Fallen angels have delivered equity-like returns for bond-like volatility[11]



Fallen angels are often large multi-nationals with large capital structures, whereas traditional high yield companies tend to be smaller businesses with less access to capital markets. For example, three of the larger fallen angels in the index are household names such as Ford, Delta Airlines and Vodafone[12]. Fallen angels were once investment grade rated and had access to capital at lower funding rates. Upon downgrade, many of these fallen angel corporations are incentivised to repair their fundamentals to get access to that cheaper capital again. As such, intuitively and empirically, fallen angels are potentially stronger rising star candidates on average.

[7] Barclays, July 2021.
[8] JP Morgan, 7 July 2021.
[9] The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed.
[10] Bloomberg, Barclays. Only contains bonds that were originally downgraded to high yield.
[11] Bloomberg, December 2004 to June 2021

PLAYING RISING STARS: FALLEN ANGELS COULD BE THE KEY

In our view, casting the net wide in a diversified, fully dedicated fallen angels strategy may be a compelling solution for a wide range of investors looking to access rising stars.

The asset class may help fit multiple needs for pension plans, such as compelling yield and income streams to cover future pension obligations and well as the growth potential to help close funding deficits and participate in the economic recovery.

Insurance investors may also benefit from the income streams of the fallen angels market, particularly if they can receive favourable capital treatment on BB rated corporate bonds given fallen angels are mainly BB rated.

We believe that investors need to consider managers with the ability to overcome the liquidity challenges of reliably delivering the performance of the fallen angels market, such as managers able to unlock the 'hidden liquidity' within the fixed income ETF infrastructure.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed Income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

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