In a falling rate environment where easy monetary policy looks set to persist for the foreseeable future, investor demand for fixed income investments offering an attractive yield will likely increase. In this paper we examine a defensive approach that focuses on the short-end of the high yield debt universe, retaining the potential for higher returns but with lower expected volatility.
The backdrop of persistent easy monetary policy and an expanding global glut of negative yielding bonds should underpin investor demand for fixed income instruments offering an attractive yield.

ULRICH GERHARD
SENIOR PORTFOLIO MANAGER – HIGH YIELD
THE APPEAL OF HIGH YIELD CREDIT IN THE CURRENT ENVIRONMENT

A glut of low and negative yields
We are in a world where attractive yield opportunities are increasingly difficult to come by. This is a falling-rate environment where easy monetary policy looks set to persist for the foreseeable future, and where 30% of the global bond stock has a negative yield (Figure 1). This backdrop should underpin investor demand for fixed income investments offering an attractive yield.

More yield, low defaults
High yield debt is well positioned to attract much of this investor demand. In terms of yield, the asset class offers an average between 3% and 6%, depending on currency, which compares favourably with the 0% to 3% available from investment grade markets and the below 1% available from government bond markets (Figure 2). Of course these government and investment grade average yields mask a vast universe of sub-zero yielding European debt.

While global default rates currently remain very low (Figure 3), the low interest rate environment gives rise to increased concerns about rising leverage and the potential for defaults further down the line. This is balanced however by the low cost of financing. With interest rates so low, debt affordability has never been better.

Proactive refinancing management
Companies in the high yield space have been proactively managing their refinancing needs by both making sure they issue replacement bonds when markets are most receptive to buying new issues and also securing refinancing well ahead of need to ensure there are no liquidity gaps. Furthermore, high yield issuers have become increasingly flexible in their willingness to adjust the maturity of new issues to suit investor preferences. We have therefore seen a wide variety of both longer- and shorter-dated bonds being issued.

A SHORT-DATED APPROACH TO HIGH YIELD
AN OASIS OF YIELD IN A YIELDLESS WORLD

IN A FALLING RATE ENVIRONMENT, WHERE EASY MONETARY POLICY LOOKS SET TO PERSIST FOR THE FORESEEABLE FUTURE, INVESTOR DEMAND FOR FIXED INCOME INVESTMENTS OFFERING AN ATTRACTIVE YIELD WILL LIKELY INCREASE. HOWEVER, A BENCHMARKED APPROACH TO HIGH YIELD MAY NOT BE IDEAL FOR MANY INCOME-ORIENTED INVESTORS. ALTERNATIVELY, A MORE DEFENSIVE APPROACH THAT Focuses ON THE SHORTER END OF THE HIGH YIELD MARKET MAY OFFER A COMPelling SOLUTION, RETAINING THE POTENTIAL FOR HIGHER RETURNS BUT WITH LOWER EXPECTED VOLATILITY.
A strong technical backdrop

Lastly, the technical background for high yield remains strong as the market continues to shrink relative to the IG market (Figure 4). Current new issuance volumes only just about match redemption amounts, meaning that any additional demand for high yield credit coming from investment grade credit investors will likely push prices up.

Figure 4: High yield market size continues to shrink in contrast to IG

POTENTIAL DRAWBACKS OF HIGH YIELD

Despite improving fundamentals, high yield investing comes with certain risks. Within high yield indices are companies with very poor fundamentals and unacceptably high levels of default risk. Approximately 16% of the global high yield index consists of issuers with a rating in the "C" rated buckets, and these credits have a 5-year cumulative loss rate of 20.5% according to Moody’s. At Insight, we tend not to invest in issuers with a senior credit rating below B-.

Given the potential for higher default losses, high yield indices generally tend to be more volatile than investment grade and government bond indices, although they compare favourably with equities and some segments of the emerging market debt complex (Figure 5). Short dated high yield enjoys comparatively lower volatility than broad-index high yield, owing to its shorter duration profile (Figure 6).

Figure 5: High yield indices have tended to perform well against equities and some segments of emerging markets, but have been more volatile than other traditional fixed income assets

Figure 6: Why invest in short-dated high yield bonds? High income, low volatility potential

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REDUCING VOLATILITY THROUGH SHORT-DATED HIGH YIELD

For investors seeking a higher yield, but with lower volatility, a short-dated approach can be more defensive than a broad-benchmarked high yield strategy. This is largely due to the ‘pull to par’ phenomenon.

Provided credit quality has not been impaired, the closer the bond gets to maturity, the more certain it is to redeem at 100% of its par value. Therefore, over time, the bonds will naturally ‘pull to par’ (see Figure 7) – whereby a fixed rate bond gravitates towards par over time whether trading at a premium or discount, assuming no impairment. With a good understanding of the company’s liquidity position it can be remarkably clear whether the issuer will be able to meet its most imminent debt obligations. For longer-dated assets, such analysis becomes progressively more challenging given the many macroeconomic and microeconomic variables at play.

Therefore, short-dated bonds are fundamentally less susceptible to changing interest rates and average credit spreads. Furthermore, debt frequently matures in short-dated portfolios, generating cash. Should yields or credit spreads rise, cash can be reinvested at higher rates to further smooth the impact of volatility.

MISPRICING OF OPPORTUNITIES IN SHORT-DATED HIGH YIELD

In the investment grade market, credit rating agencies typically assign different credit ratings to the same issuer’s shorter-dated and longer-dated bonds. Pricing of investment grade credit curves is therefore relatively steep – reflecting lower credit spreads on short-dated bonds. However, in high yield, the same dynamic does not apply. Issuers typically receive only a single credit rating for all their debt regardless of maturity. This results in flatter credit curves and, in our view, often disproportionate value in short-dated high yield (Figure 8).

The lack of short-dated high yield bond indices adds to the market’s structural inefficiency. This can provide active managers with opportunities to exploit mispricings in short-dated bonds.

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8 Source: Credit Suisse, July 2019. 9 Source: Bank of America Merrill Lynch as at August 2019. Excludes Financials.
OPPORTUNITIES IN CALLABLE BONDS

Unlike in the investment grade market, most high yield bonds are callable, meaning the issuer has the option of redeeming a bond before the maturity date. This is usually allowable at specific intervals (such as each year) after an initial ‘non-call’ period has elapsed (typically the first three or five years after it has been issued). In practice, this reduces the life of most bonds, as most are called prior to maturity. We seek to identify events that may prompt an issuer to call their bonds.

Debt can be called early for a number of reasons. Lower interest rates typically heightens the market’s expectations for early bond redemptions. When a company’s business develops and its credit quality improves, it may be upgraded or experience a contraction in its credit spreads. Calling its existing debt will allow the company to refinance more cheaply. Figure 9 shows recent trends in the percentage of global high yield bonds trading to an early call. Global central banks’ pivot back to a dovish stance has contributed to the an increase of this percentage in 2019.

Similarly, unlike investment grade debt, high yield bonds typically have a number of structural protections, such as security against underlying assets or covenant protections. Many of these can restrict or deter a company from activity that allows it to pursue growth, such as selling assets pledged as security, paying dividends to shareholders or otherwise assuming greater leverage. If a company’s credit quality has improved, it will likely prefer to refinance with debt that imposes fewer restrictions.

Investors focusing on credit quality can therefore add value by investing in bonds in companies that have an improving credit profile, where they have a strong conviction that its bonds will redeem early. Again, understanding the company’s liquidity position will also provide strong clarity regarding its ability and incentive to repay.

Figure 9: Credit and sector strategy: high yield – positive technical factors

TAKING A FUNDAMENTAL VALUE-DRIVEN APPROACH TO EXPLOIT OPPORTUNITIES

High yield markets are sensitive to shifts in market sentiment, due to their ‘high beta’ nature. Episodes of volatility have been common since the financial crisis and are likely to continue, particularly given considerations such as political risk. For example, following the UK’s referendum on EU membership in June 2016, European high yield credit spreads suddenly widened around 80bp, before recovering almost as sharply. When markets rise or fall, high yield tends to experience inflows or outflows, respectively. Short-dated bonds (which tend to be more liquid) are often impacted first, particularly during a sell-off. This is ironic as they are generally the least likely to be fundamentally impaired if a company’s liquidity position is robust.

However, this creates an opportunity. Investors willing to adopt a contrarian approach during these times may be able to buy bonds cheaply relative to their fundamental value. Similarly, when markets rally, high yield can become expensive. Taking profits and building up significant cash during such episodes (that can be spent during the next sell-off) could be advantageous.

A value-based style such as this is counter-intuitive for many investors. It requires diligence, fair-value analysis and rigorous credit work in a market often driven by transient sentiment. However, such an approach is well-suited to short-dated high yield. This is because credit analysts can acquire an excellent understanding of a bond’s fundamental value based on the issuer’s access to financing options. Furthermore, it can offer the best visibility as to whether an issuer has an improving credit profile that may lead to refinancing a bond early.

10 Source: Credit Suisse, July 2019.
Investors focusing on credit quality can add value by investing in bonds that have an improving credit profile, where they have a strong conviction that its bonds will redeem early.

ULRICH GERHARD
SENIOR PORTFOLIO MANAGER – HIGH YIELD
A global approach to high yield can maximise relative value opportunities, particularly as the global market has matured, making regional diversification compelling. The market value of global high yield markets has roughly quadrupled over the last 15 years or so (see Figure 9). This is partly because, since the financial crisis, fewer corporates have been in a position to receive financing from banks and have turned to non-bank alternatives (such as bond issuance) instead.

The European market is young with the first bonds issued in 1997. However, it now offers significant depth and diversification. Historically, it offered low levels of structural protection and an average single-B credit quality. Today, seniority and security are increasingly common and over 70% of the market is BB-rated, compared to 47% for the US market. The US high yield market offers its own advantages. It is four times larger and significantly more liquid. While the European high yield market now contains over 290 unique issuers, the US market has almost 900.

From a regional perspective, the US dollar market contains over 85% exposure to US companies. The euro market has 14% exposure to France and 10% to Germany, while Italy commands the largest weighting at 15%. This means a significant proportion of European high yield is exposed to peripheral Europe. Concentration risk is also significant. Given the relatively small size of the market, ‘fallen angels’ (former investment grade issuers that were downgraded particularly during the financial crisis), occupy relatively large shares of the European high yield market. Italy’s Telecom Italia is one such example, accounting for 5% of the entire European high yield market. In the US market, concentration risk is less of an issue, although the largest issuers, Sprint and Charter Communications, still account for close to 2% of the market respectively.

The markets also differ on a sector basis. The US is substantially more exposed to the oil markets, with 13% exposure to energy. This sector was the source of a substantial uptick in defaults in 2015 (which were isolated to the sector), but also the source of a strong rebound in 2016. A global approach provides investors with far larger universe from which to pick and choose optimal sectoral or regional exposure.

It is notable that several companies issue debt in both euros and US dollars, and their bonds can trade differently in each market, providing relative value opportunities. Diverging global monetary policy contributes significantly to this. The euro high yield market, for example, has been indirectly influenced by the European Central Bank’s investment grade corporate bond purchase initiative. But as no equivalent program exists in the US, pricing dynamics differ. With too few managers investing across both markets, these inefficiencies and pricing differences will likely persist.

Divergence in pricing (see Figure 10) also illustrates the benefits of diversification. The US dollar market has a larger proportion of single-B issuers, while the European single-Bs are significantly weighted toward peripheral Europe.

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Figure 9: The high yield market has grown substantially

![Figure 9: The high yield market has grown substantially](image)

Figure 10: US and European high yield 5-year spread history

![Figure 10: US and European high yield 5-year spread history](image)

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SUCCESSFULLY INVESTING IN SHORT-DATED HIGH YIELD

High yield is a specialist investment area and demands substantial skill and resources. As defaults can inflict substantial losses, a focus on bottom-up credit analysis is required. We believe analysts need to focus on the areas highlighted in Figure 11. Understanding a business profile requires a strengths, weaknesses, opportunities and threats (SWOT) analysis and a competitor review. High yield companies often have investment grade peers, an ideal yardstick for financial comparisons. This demands credit coverage across all markets. Free cash flow can also be an important determinant of the issuer’s financial viability. The ability of the company to call (redeem early) or not call its bond can also directly impact its value.

The terms and conditions regarding a high yield bond can be complicated and term sheets are frequently several hundreds of pages long. They include details regarding structural protections such as seniority (the bond’s priority in the capital structure), security against company assets and debt covenants. The latter can help ensure a bond’s credit quality is not compromised by company management. Structural protections do not typically apply to investment grade bonds.

The sources of a company’s liquidity (see Figure 12) are a crucial determinant of its ability to repay. When investment grade companies have no cash available to repay the bond’s principal they can usually draw on a revolving credit facility. However, high yield companies will not typically have a facility that is large enough. Furthermore, for high yield companies the facility is typically secured against inventories, further blocking available sources of liquidity. It also typically comes with debt covenants that can further restrict the issuer’s available liquidity. Similarly, the issuer’s bank or bond covenants can also be restrictive. High yield companies without enough available liquidity may need to revert to asset sales as a last measure, but this would not be sustainable.

In a worst-case default scenario, the issuer’s debt will be restructured. Investors with the practical and legal understanding of the restructuring process will be best placed to ensure the best recovery rates on the bonds.

CONCLUSION: STABLE INCOME IN AN UNSTABLE ENVIRONMENT

High yield markets are typically vulnerable to default rates. Default rates are currently low and look set to remain benign over the coming year. However, volatility is inevitable in a world where monetary policy has entered unchartered territory and global politics are increasingly uncertain. Prudent investors seeking income rather than growth through high yield bonds should adopt a considered approach to risk, backed-up by a rigorous, analytical and diverse investment approach.

**Figure 11: The keys to unlocking fundamental value through analysis**

**Figure 12: Understanding the sources of liquidity for high yield companies**

- **Revolving credit facility**
  - used by high yield issuers for working capital purposes only, not to repay debt (contrary to investment grade issuers)

- **Free cashflow**
  - most high yield business do not generate sufficient cash flow to pay off bonds, but may reduce bank loans to improve their credit rating

- **Bank covenants**
  - lose maintenance covenants provide companies flexibility – good for short-maturity bondholders
  - tight bank covenants can cut off access to liquidity when it is most needed

- **Bond covenants**
  - if restrictive can lead an acquiring company to tender for the bond
  - covenants can have a material impact on the bond in cases of ‘change of control’, puttable bonds and corporate actions
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.

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

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

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

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Ulrich joined Insight in September 2011 as a Senior Credit Analyst within the Fixed Income Group. He became a Portfolio Manager in June 2012 and is responsible for the high yield strategy. Prior to joining Insight, Ulrich was a senior analyst and portfolio manager at Paternoster Services Ltd where he was responsible for managing investment grade sterling portfolios. Ulrich started his career in the industry in 1997 with Saudi International Bank (now Gulf International Bank) as a high yield trainee analyst initially looking at the global chemical industry for high yield and investment grade credit research and later portfolio management. Ulrich graduated in 1993 with a BA degree in Chemistry from the University of Kaiserslautern. In 1997 Ulrich gained a PhD in Organic Chemistry from Cambridge University. He also attended the JP Morgan credit training programme for analysts in New York in 1998.

Cathy Braganza – Deputy Portfolio Manager and Senior Credit Analyst, Fixed Income
Cathy joined Insight in September 2012 as a Senior Credit Analyst within the Fixed Income Group. Prior to this role she worked at Citi where she was an Analyst focussing on high yield and distressed stocks. Cathy has previously worked as a Portfolio Manager at Saudi International Bank (now Gulf International Bank). She began her industry career in 1994 as a Portfolio Manager with AMP Asset Management. Cathy holds a B Commerce degree in Finance/Economics from the University of New South Wales.