Insight INVESTMENT

# HIGH YIELD

## MANAGING RISING RATES THROUGH SHORT DATED HIGH YIELD

NOVEMBER 2018

> Rising rates have had a significant impact on financial markets since the summer. The prospect of normalising interest rate policy in developed markets has been a concern for investors in high yield.

Part of BNY MELLON

# SUMMARY

In our view, there is enormous value in having the flexibility to take a global approach to high yield investing. For short-dated high yield funds, we believe that too many funds are constrained to investing in Europe only, which, as a result of increasing index duration, has become more sensitive to interest rates. Historically low yields have led to increasing volumes of issuance with coupons in the 2-3% range in recent years, which we view as having little chance of being redeemed before maturity. These issues are now a significant proportion of European high yield bond indices. We believe that the following strategies will allow investors to protect themselves against rising interest rates:

- A global approach, rather than a regional focus
- Focus on short dated and callable securities, where fundamental analysis supports the belief that there is a strong incentive for management to refinance
- Underweight longer maturity issues, especially those where there is a low incentive for refinancing such as those bonds with particularly low coupons. Unless an investor hedges the rate exposure in long dated, low coupon bonds, we do not believe that investors are compensated for the mark-to-market risk (that is inherent in high yield). In addition, in the current rate environment, coupon rates can have an important impact on price volatility
- Underweight bonds in the BB credit rating category, versus bonds in the B credit rating category

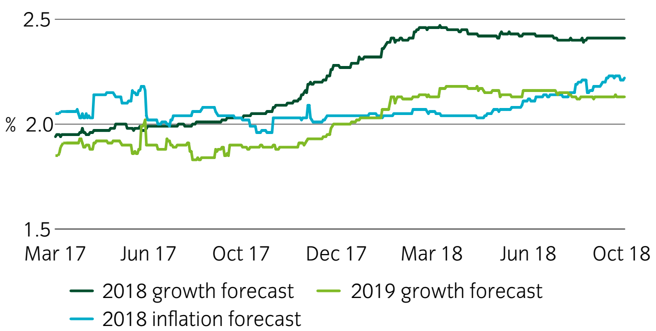
# HIGH YIELD
# MANAGING RISING RATES THROUGH SHORT DATED HIGH YIELD

A RECENT FEAR FOR HIGH YIELD INVESTORS HAS BEEN THE PROSPECT OF NORMALISING INTEREST RATE POLICY IN DEVELOPED MARKETS. WE OUTLINE THE VALUE OF A FLEXIBLE APPROACH TO HIGH YIELD INVESTMENT AND THE VARIOUS STRATEGIES THAT CAN BE UNDERTAKEN TO PROTECT AGAINST RISING INTEREST RATES.

## THE CURRENT CYCLE IS NOT A TRADITIONAL ONE

It is clear that both the US Federal Reserve and European Central Bank are now in the process of normalising monetary policy, with the US obviously furthest along that path. In recent years, the global economy experienced a broad upswing, buoying sentiment and leading to a decline in spare capacity in most economies. This has firmly underpinned the more hawkish position of the US Federal Reserve, and the ending of quantitative easing in the eurozone. But, this current cycle continues to be quite different from many historical examples. In a more traditional cycle, as spare capacity declines, inflation accelerates and central banks are forced to tighten monetary policy in order to contain inflation. In the current cycle, inflation has not been a significant concern, allowing central banks to maintain an unprecedented level of stimulus even after data showed economies growing strongly. Even now, with spare capacity having rapidly declined, inflation continues to be elusive. Developed market inflation forecasts have risen for 2018 and 2019, but the level of inflation is not problematic and is expected to moderate between 2018 and 2019. (see Figure 1).

Figure 1: Consensus forecast for developed market growth and inflation[1]

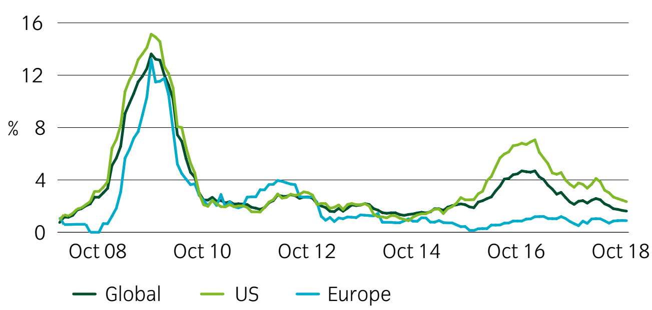



## GRADUAL NORMALISATION

So far, this has allowed central banks to be able to take a gradual approach to normalising policy rather than the more rapid approach that would be needed if inflation were more problematic. US 10 year rates have moved upwards from 2.4% at the start of 2018 to above 3% and in Europe, 10 year German bond yields are now firmly in positive territory. Although an upward shift, these yields remain low in a historical context. For investors in corporate bonds, the combination of stronger growth, still moderate inflation and only gradually rising inflation has created a positive backdrop for corporate earnings, which have grown strongly. This has underpinned credit ratings, especially in high yield.

The environment has also had an additional benefit for investors. Default rates have declined globally, in Europe default rates are now at historically very low levels (see Figure 2) and are not expected to rise significantly over the next two years.

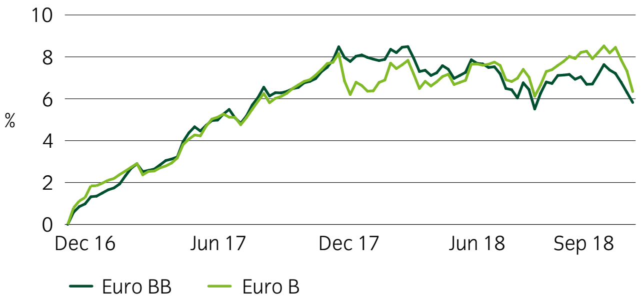
Figure 2: Global default rates[2]




[1] Source: Bloomberg. Data as at 31 October 2018. [2] Source: Bank of America Merrill Lynch. Data as at 31 October 2018.

The positive economic backdrop and low default rates led to attractive returns for European high yield investors in recent years. In 2018 however, rising interest rates have led to price declines with income only partially counterbalancing this. In Europe, BB rated bonds have underperformed in 2018, with investment grade investors reducing their exposure to high yield investments and concerns that ECB purchases are coming to an end.

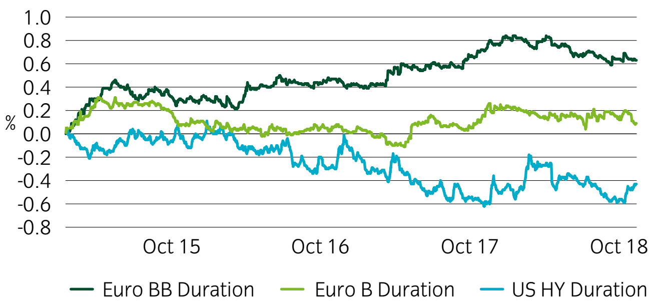
Figure 3: Total Return Euro high yield end 2016 to 31 October 2018 (In Euros)[3]




## RISING INTEREST RATE SENSITIVITY

It is of course possible for investors to look at historical periods and examine how high yield performed during previous tightening cycles. Returns in the high yield market are driven by (1) spreads and default rates and (2) movements in interest rates. Traditionally, the first factor has dominated returns, but the sensitivity of the high yield market to interest rate movements has now increased. European issuers, especially BB rated issuers, have used the period of low yields and strong demand to extend their maturity profiles (see Figure 4). This has added duration risk for investors following mainstream benchmarks. The coupons on these new issues have been low, with several securities issued with coupons in the 2-3% range. For these low coupon securities, assuming there is no dramatic change in company fundamentals, interest rate risk would be expected to be a significant driver of future returns. In the US, the trend has diverged significantly, with US dollar duration falling.

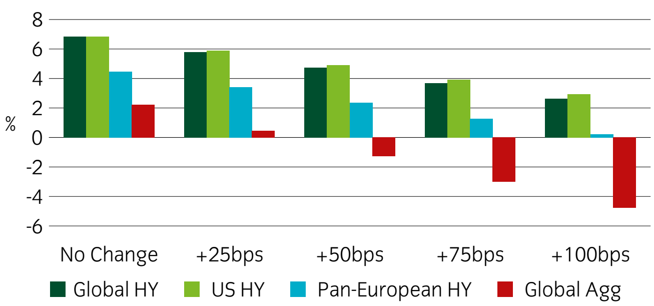
Figure 4: Change in duration, Bloomberg Barclays high yield index from end 2014[3]




## ANALYSING RISING INTEREST RATE SCENARIOS

Given this change in duration and the benign economic backdrop, we believe that the best way for investors to assess the potential impact of rising rates is to use scenario analysis. Using the Bloomberg Barclays High Yield indices as a model we can calculate the expected total returns under various scenarios for changes in yields (see Figure 5). In this analysis we assume no change in spreads or defaults, so the return from the index comes solely from the movement in prices resulting from changing yields and income.

Figure 5: 12 month total returns under various yield change scenarios[3]




By undertaking this analysis it becomes clear that yields are sufficiently high in high yield to absorb the negative price impact of a broad-based rise in bond yields under most scenarios up to a 100bp rise in yields. If there was a 100bp rise in European bond

[3] Source: Bloomberg, Barclays. Data as at 31 October 2018. Forecast returns are based upon certain assumptions considered reasonable. They are speculative in nature and actual results may differ materially.

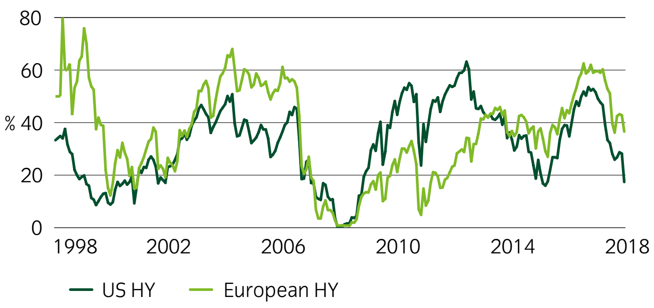
yields, the European index would generate a negative return over a one year period, primarily as a result of the increase in duration in that index over recent years. For investors with exposure to government bonds, however, there is far less yield protection and greater duration risk. The Barclays Aggregate Index, which is comprised mostly of government debt, would be expected to generate a negative return with even a 50bp rise in yields and substantial losses under a scenario where yields rose by 100bps. Unless there is a dramatic deterioration in the economic outlook which in turn feeds into corporate fundamentals, index returns this year should be primarily driven by interest rate movements and income.

## THE CALL EFFECT

An additional concern for high yield bonds during periods of rising interest rates is the fact that many high yield bonds are callable. This means that the issuer can choose to redeem the bonds at set dates, at a premium, before the bonds' final maturity date. The call schedule normally starts two to three years after a bond is issued. The ability of the issuer to call their bonds makes the calculation of duration, and the impact of changing interest rates on bond prices, more complicated.

When interest rates are falling, issuers call bonds before their scheduled maturity, refinancing the debt on better terms. However, when interest rates are rising, the opposite is true, and issuers have an incentive to keep paying the lower interest rates on the existing bond for as long as possible. Bond prices can vary considerably, depending on where in their call schedule investors believe a bond will actually be called, or if it is expected to run until final maturity. The percentage of bonds trading as if their call date were their maturity (trading to call) has declined sharply in both the US and eurozone in 2018, but the US is at a more advanced stage of the process (see Figure 6).

Figure 6: Percentage of high yield issues trading to call[4]




## FINDING THE RIGHT CANDIDATE

A company's ability to repay the principal on their debt, which we refer to as their path to liquidity, is often dependent on their ability to access the debt market. We look for companies whose management are strongly incentivised to refinance, redeeming their debt before maturity at a premium. For these issues, the risk that the bonds will not be called when expected, commonly known as extension risk, is minimised. Companies whose fundamentals are on an improving path, particularly relative to when they issued the bond, are good candidates.

For issuers, the motive for debt redemption is not just the lower cost of capital that comes as a result of refinancing their debt on better terms. Companies are often incentivised to refinance in order to manage their liquidity and maturity profile, have greater flexibility on their indentures, or for a specific reason (such as part of raising capital to fund a particular acquisition). Understanding these companies, through rigorous analysis, is critical to understanding extension risk.

### A point on coupons and rate risk

Coupon rates can play a role in this process, and issuers with high coupon rates, particularly relative to where they can borrow at the present time, are often subject to additional pressure to refinance their debt at the earliest opportunity. In addition, coupon rates can have an impact on price volatility.

The market convention in the high yield market is to price a security to the date when it is most economical for the issuer to redeem it (the 'yield to worst'). As rates increase, the market will price securities to a later redemption date – increasing the duration of the security (and hence the sensitivity to movements in rates).

This pricing convention can create opportunities. For example, as investors, we often take the view that the issuer will redeem a security earlier (or later) than the redemption date the market is pricing it to. However, a rising rate environment can have a negative impact on high yield prices, as the market will price a high yield bond to a later redemption rate.

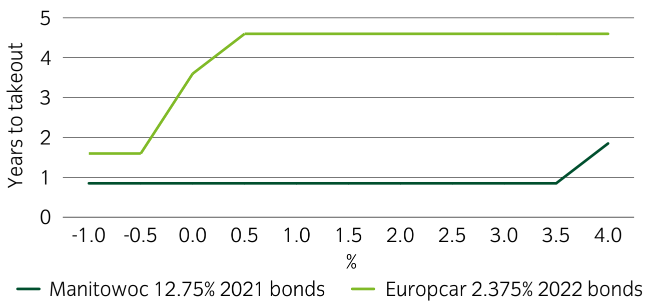
As an example of how important coupon rates can be, we can examine two high yield issues with very different coupon rates:

- A 2021 bond with a coupon of 12.75% issued by Manitowoc, a US industrial manufacturer
- A 2022 bond with a coupon of 2.375% issued by Europcar, a French car rental firm

[4] Source: Bank of America Merrill Lynch. Data as at 31 October 2018.

At the current level of yields, the Manitowoc bond will price as if the maturity will be the date at which it can be first called, in 2019, whilst the Europcar bond will price as if its maturity is its November 2021 call date. If yields were to rise, just a 50bp increase would likely result in markets repricing the Europcar bond to mature at its final maturity in 2022 – extending the maturity by one year. For the Manitowoc issue, a move of at least 400bp over the next 12 months would likely be needed for markets to stop pricing the bond as maturing in 2019. On the other hand, if interest rates were to fall, a 50bp drop in yields would likely result in markets repricing the Europcar bond to its first call date in 2019 – reducing the maturity by two years. A 50bp drop in yields would have no impact on the Manitowoc issue.

Figure 7: Example, low coupon versus high coupon bond[5]




## CONCLUSION

Irrespective of interest rate moves, an approach to high yield investing which combines a focus on short dated opportunities, a global approach to investing and rigorous credit analysis, should deliver superior returns over time. But, historically low interest rates have made the high yield market more sensitive to interest rate moves than in the past and effectively managing interest rate risk will be  important for high yield investors in the coming years. The rise in duration of European indices leaves passive investors with a greater exposure to interest rate risk, just as yields are starting to rise. In this environment, we believe investors need to have the flexibility to actively manage duration and extension risk in high yield.

It is also important for investors to keep a close eye on the nature of the economic cycle and to take a global approach. If growth continues to be strong and interest rate rises gradual as a result of only moderate inflation, then this should minimise market disruption, keep default rates low and support corporate earnings and credit ratings. The ability to flexibly allocate between regions allows investors to take advantage of the more advanced repricing of US high yield to reflect extension risks, and to pursue strategies which avoid the low coupon, more interest rate sensitive issues in Europe. BB rated issuers have opted to issue with much longer maturities, and in may cases without any callable language. This leaves us favouring B rated issuance.

Ultimately, although rising yields could rise and impact returns, we believe the income available from high yield debt is sufficient to absorb quite significant price declines. For European high yield investors, the higher yield available in the US acts as a greater buffer and extension risks are better priced into the US market. Relative to government or investment grade bonds, the yield buffer provided by high yield provides significantly greater protection against rising yields, as long as the economic environment remains supportive.

## CONTRIBUTORS


Ulrich Gerhard,
Senior Portfolio Manager,
Insight Investment

Cathy Braganza,
Senior Credit Analyst,
Insight Investment

Simon Down,
Senior Content Specialist,
Insight Investment


[5] Source: Bloomberg, Insight Investment. For illustrative purposes, data as at 28 February 2018.

## IMPORTANT INFORMATION

### RISK DISCLOSURES

**Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

### ASSOCIATED INVESTMENT RISKS

**Fixed income**

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

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.

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**Institutional Business Development**
businessdevelopment@insightinvestment.com
+44 20 7321 1552

**European Business Development**
europe@insightinvestment.com
+44 20 7321 1928

**Consultant Relationship Management**
consultantrelations@insightinvestment.com
+44 20 7321 1023

**@InsightInvestIM**

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