INVESTMENT

Lost in the woods

The high-yield bond markets have experienced a rollercoaster ride in recent times due to liquidity issues and falling prices. Sandra Haurant **explores the fluctuations in this asset class and what the future has to offer**

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Pre-1980s, high-yield bonds - also known as non-investment-grade bonds or junk bonds - were reserved for fallen angels, those firms who had started out with investment-grade bonds and faced problems forcing their credit grade down. Now they are also likely to be issued by firms that have a credit rating of BBB or below at the outset.

A rollercoaster ride

The high-yield bond market has had something of a rollercoaster ride over the past few years, and the end of 2014 saw fears that problems in the US energy sector might bring about widespread defaults. But then in March 2015 there were claims that the US high yield bond market was doing just fine. Indeed, one *FT* headline cried out: “High-yield debt market defies sceptics.”

At that stage, investors were turning to the US high-yield market and moving away from European high-yield bonds in search of yield. But by the summer, the picture was very different. Concerns about oil prices and further trouble in the energy market proved justified, and high-yield bonds didn’t really live up to their name. They were not offering high yields at all – in fact, quite the opposite. It has been a volatile time.

“Looking back at 2015, it has been a very choppy year for high yield,” AXA IM high yield fund manager Yves Berger states. “Although we should make the distinction between the US and Europe. Overall Europe did pretty well compared with the US, which was down 4.5 per cent, while Europe was up 1.8 per cent.” Although 1.8 per cent is hardly anything to write home about – making high-yield bonds something of a misnomer.

The biggest problem was the energy sector. “It’s a big factor for the US because it is such a big part of their universe,” Berger says. “By contrast, it is only 1 per cent of our European universe so it is not a meaningful proportion.” The tiny proportion of energy – the main area in which the European market is correlated with the US – has served to isolate this side of the Atlantic from the losses seen Stateside. And as the size of the energy market has increased in the US, the issues it faces have also grown.

“The notional size of energy in the high-yield market has effectively doubled over the past five years and as part of that the energy market issued a lot of bonds,” CQS head of strategy and research Matthew James explains. “So the supply or net growth of the US high-yield market is a factor to consider.” What’s more, he adds: “What we have seen is the doubling of a higher risk sector overall. And this

is a sector that just got hammered by a collapse in oil prices."

By contrast, James says, there has been very little increase in European high-yield stock in the last three years and the region is typically heavier in the financial sector with energy playing such a small part that it is pretty much name-specific. Berger cites Gazprom and Petrobras as examples.

Petrobras, the Brazilian oil company that had sold bonds on European markets among others, was downgraded in 2015 to junk status. The firm has been under pressure with falling oil prices, as well as being at the centre of political and corporate turmoil.

"Brazil as a country is not performing, and the company has had a lot of problems," Berger comments. "Gazprom, on the other hand, is a perfectly functioning company, but it is Russian, and so when Russia was downgraded, it was automatically downgraded too."

We have, then, seen a year of ups and downs in 2015 that has shaken sentiment and left investors a little reticent when it comes to the high-yield bond market. Have we come full circle to levels of concern we saw as we approached 2015? "I believe so," PiRho Investment Consulting director Phil Irvine states. "It was bad in 2015 and I don't think we are out of the woods yet."

Pricing in

The issues faced by high yield-bonds, though, are common across the asset class. But Irvine believes that the bad news is perhaps not entirely priced in at present. "The junk bond market can be split so far between those bonds issued by energy and mining companies, which have been hit by the fall in commodity prices, and the rest, which have held up pretty well."

However, he adds that, after low default rates for a number of years, there may now be contagion, due to a firm US dollar and the energy slowdown. "This is not a typically good environment for buying high-yield bonds," he says. Instead, Irvine says, the best time to buy is: "Normally when things look the bleakest in a recession. The best time to get relative out-performance of junk bonds is when the economic outlook is bleak in the middle of a recession, default risk is priced in and yields are relatively stretched."

For now, that risk is perhaps not sufficiently priced in, he argues: "Yield valuations of junk are relatively high versus corporates, but not at the all-time peaks associated with recession. It is worth noting that the redemption yield of the junk bond index can fall if companies start defaulting on payments. Selective investment in credit and high yield rather than wholesale purchases would be the best strategy *[now]*."

Indeed, direct credit has been attracting the attention of institutional investors and some argue, in certain cases, it offers a more suitable set of criteria than high-yield bonds. For CQS, which has a flexible approach to credit investment, selecting the most appropriate asset classes for each portfolio, there have been times over the past year and more where credit offered what was needed. After all, James says: "High-yield bonds offer less security than senior secured loans, which are further up the capital structure. From January 2014 to October 2015, you could buy European loans, which were more senior in the capital structure, cheaper than high-yield bonds. So you got a better security at a cheaper price. That was a trade we liked. Now, in Europe, the reverse is true and we are once again favouring high yield."

With leveraged loans come a different set of risks – at the top of the list is perhaps liquidity. "The European high-yield bond investor has more vehicles with daily liquidity, such as Ucits, while senior secured loans are in more locked-up liquidity vehicles such as CLOs."

"The liquidity concerns of loans are even more concerning than debt," Irvine argues. "I would urge any pension scheme to think carefully if they are relying on the liquidity of these 'growth assets' when combining with a leveraged liability-driven investment (LDI) approach."

Liquidity

Liquidity can also be an issue for high-yield bonds, though, as has recently become apparent when Third Avenue froze its junk bond fund in December. Much of the problem was linked to a proportion of inappropriately illiquid assets within what should have been a daily liquidity fund, Morningstar head of portfolio management, EMEA, Robin Johnson says.

Nonetheless, many argue the current climate is creating opportunities. And James can see plenty of opportunity for the flexible institutional investor. "We have for the last four to six weeks been adding to the non-energy triple C part of US high-yield bonds because we think you have the opportunity to buy assets with high yield but at very attractive prices, because they are sold by forced sellers."

Nonetheless, it is a market where caution and a full understanding of the risks is essential. "There is a reason yields are higher on bonds with lower-rated credit ratings – the risks are there and that is reflected in the grading they get," Johnson concludes. ■