INVESTMENT GRADE

INVESTMENT

A tough match up

Adam Cadle explores the developments within the high yield versus investment grade debate and where the popularity lies

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An environment of low interest rates and economic uncertainty across Europe brings with it the need for European pension funds to continuously analyse and modify their investment strategies in order to obtain appropriate return levels. The fixed-income sector is part of this investment sphere, forming an integral part of many pension funds' portfolios. Linked to this is the high-yield versus investment-grade bond debate, which resurfaces on a frequent basis as European pension funds explore which asset class should form the most significant part of their portfolios.

Due to the long-term investment horizon of pension funds, fixed-income securities represent a large share of portfolio asset allocation with an average 50 per cent of investments, according to EIOPA. "Within their fixed-income holdings, pension funds allocate a large part, around 30 per cent, in sovereign debt to match their long-term liabilities," Candriam global head of fixed income management Nicolas Forest says.

"However, the past 10 years have seen bond yields consistently moving lower, even recording a negative level of -0.15 per cent last September. This low interest rate environment has pushed them to diversify towards higher-yielding products such as investment-grade and high-yield asset classes to generate returns."

These areas are not stable however, as regulation and political uncertainty morph the landscape. Over the past few years high-yield credit has become much more of a lever to generate returns, as investment-grade spreads and yields have decreased to historical lows. "This has been driven by extraordinary European Central Bank bond buying, in both the sovereign bond and corporate bond markets," Janus Capital Group portfolio managers Annika Eiremo and Ryan Myerberg explain. Indeed, according to Stone Harbor Investment Partners portfolio manager, multi-sector strategies, David Scott: "2016 was an exceptionally positive year for credit markets with high-yield excess returns at 16 per cent for the calendar year."

The answer to the question of how to weight exposure to credit asset classes within European pension portfolios largely depends upon the regulatory environment each fund operates in. Due to the size of the market, credit worthiness of the issuers, and yields on offer, investment-grade credit has traditionally played a major role in generating income within portfolios. On the flip side, the growth in the European high-yield market has been driven by many factors, but certainly the availability of relatively cheap refinancing opportunities has been a key driver. One notable evolution of late has been the re-emergence of so-called 'covenant-light' or 'cov-lite' high-yield issues in European markets; where some issuers take advantage of investor demand to reduce the level of investor protections written into new bonds deals.

"As ever, caveat emptor applies, and investors are well advised to ensure that they have a good understanding of the bond documentation, and not just the credit rating, of a high-yield bond issue," M&G Investments head of institutional fixed income portfolio management David Lloyd comments.

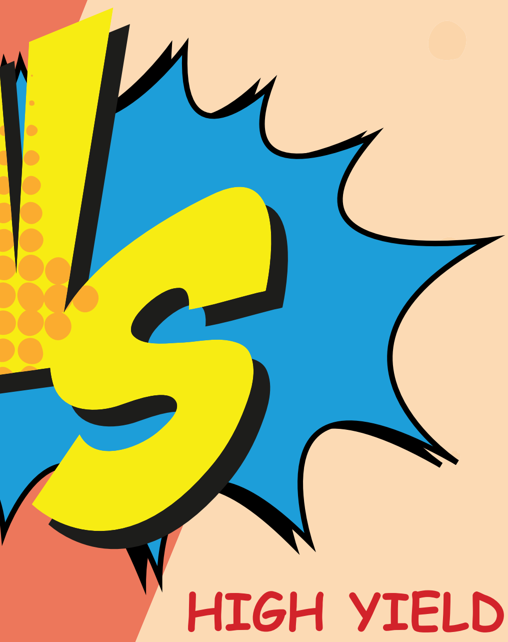
Benefits/negatives

So which asset class is the real winner? As Eiremo and Myerberg put it, "the benefit of investment-grade credit is its ability to provide a yield pick up over the risk-free rate, while not materially increasing default risk".

"However, the outright yields on offer make it difficult for investors to meet prescribed return targets. Likewise, duration risk has increased as yields have gone lower. High yield, as the name suggests, provides the benefit of higher rates of income per annum than investment grade, albeit with higher risk of capital loss."

Eaton Vance portfolio manager Jeff Mueller prefers high yield.

"While compressed valuations leave both the investment-grade and high-yield asset classes vulnerable to a pullback in risk appetite, we continue to favour high yield over investment grade for two main reasons: slow but steady economic growth, decreasing leverage, high interest coverage and low defaults should lead to supportive fundamentals in the high-yield asset class, while the longer duration



characteristics leave the investment-grade market more exposed to moves in underlying yields, which would provide greater headwinds in a rising rate environment. While both asset classes should continue to play a large role in the funding of pension plans in Europe, we believe taking selective credit risk over duration risk should provide more attractive risk-adjusted returns in the current market environment."

For Legal & General Investment Management head of credit strategy, active fixed income, Ben Bennett "nothing comes for free" however.

"If yields fall and credit risk increases, investors may want to be in the relative safety of investment grade credit. Ultimately there is default risk within high yield, and under extreme conditions, some bonds can lose 30 to 40 per cent or more in a year."

Fidelity International investment director Andrea Iannelli says current investment-grade bond valuations are challenging and has high hopes for European high yield.

"As at the end of January 2017 index yields of investment-grade corporate European bonds were just over 1 per cent (Merrill Lynch EMU Corp index ER00) and we expect that, over a five-year horizon, a passive investment in European corporate bonds to return less than 0.5 per cent annualised. This is significantly below the return target of many pension funds.

"Investing internationally in investment-grade bonds doesn't provide significantly better value opportunities or expected returns for European investors as much of the yield differential will be removed once interest rate and currency risks are hedged.

"To target higher expected returns in a balanced way, higher risk and return diversifiers such as high yield can be included in a pension fund's asset allocation. For example, we expect European high yield to outperform European investment grade by in the region of 2 per cent over the next five years, in our base economic scenario."

Political uncertainty

Whilst the benefits and negatives of both investment-grade and high-yield bonds can be discussed at length, both investment areas can be thrown wayward by the threat of political uncertainty. This looks set to continue. Upcoming elections in Italy, France, Germany and the Netherlands will set the stage for the Franco-German leadership, for Brexit, EMU consolidation and more generally for a vision for the future of the EU.

"If Article 50 for Brexit is indeed triggered in March, the negotiations will be taking place during campaign seasons, and may be subject to a lot of posturing, most likely leading to renewed fears of a 'hard' Brexit," AXA IM head of buy and maintain credit strategies Lionel Pernias comments.

"However, the final timeframe and specific details around Brexit negotiations will be unknown for some time. Donald Trump's victory also highlights very clearly the risk that anti-establishment parties may do well at these elections, potentially endangering the current fragile political consensus around ECB's quantitative easing.

"We continue to monitor the situation for more clarity regarding the longer-term implications of economic policy. We think political risk will increase volatility in credit markets. Market concerns are starting to emerge over the far-right presidential momentum with underperformance of French bonds. We think global diversification is paramount and we expect less uncertainty in the second part of this year."

What's the outlook?

The outlook for high yield and investment grade really depends upon the individual pension fund's view on economic growth and interest rates.

"We still think the world is weighed down by too much debt, and ultimately policymakers will struggle to raise interest rates very much before negatively impacting growth," Bennett says.

"If this is the case, investment grade seems the safest option right now. But central banks are likely to step in again with support. And as yields fall once more, we may be attracted by the extra pick up offered by high yield."

The changing of the European political and financial landscape looks to be an interesting one over the coming years, with a multitude of elements potentially having the power to have a significant impact on how it all unfolds. Investment-grade credit and high-yield bonds will be firmly at the core of this as to how European pension funds combat this volatility. ■