Henderson Global Investors

Industry Views

You need freedom to find safety

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Mention the words ‘unconstrained’ and ‘high yield’ in the same sentence, and certain risk-averse investors will begin to worry. However, it is the strategic freedom and the access to select high-yield credit opportunities that have helped the wise fixed-income investor through May.

It has been said that steering monetary policy is like driving along a winding road looking only in the rear view mirror. Much of the data that central banks rely upon are lagging and often backward looking. When the momentum stalls and economic indicators become less reliable, many investors conclude that central banks (especially a “data-dependent” US Fed) do not have the information necessary to implement monetary policy with strong conviction about where inflation and growth might be heading.

This phenomenon led to rising interest rate uncertainty in the US recently. Coupled with the prospect of rising interest rates, it caused increased nervousness and volatility in financial markets generally, and resulted in material signs of risk aversion throughout May. This behaviour was not limited to the US. European markets, while not solely reliant on the US economy, tend to mimic US markets closely, and May was no exception. Many major worldwide equity markets fell, and benchmark bonds in most markets, after a brief pause over inflation concerns, rallied as investors embarked on a flight to safety.

A ‘blend or trend’ approach to fixed-income investing is a course to navigate through both choppy and fair-weather markets. In a directional market, when a solid interest rate trend is in place, for instance, performance will predominately come from top-down strategies such as interest rate management, with some blending of assets in addition to structural strategies. In a directionless market, however, managers can employ a blend of uncorrelated asset-allocation strategies and use diversity to isolate a fund from broader market volatility.

May was a demonstration of how quickly investor sentiment can turn markets. Sovereign bonds rallied as risk-averse investors sought risk-free assets, and, broadly speaking, high-yield bonds drifted in a volatile manner. If the managers of the fund were not permitted to blend various asset classes in order to achieve adequate diversification, as might have been the case with a constrained high-yield manager, their fund would have fallen. However, managers of unconstrained funds were in complete control of asset allocation and the resulting blend of uncorrelated strategies should have produced a neutral result for the month.

Much stigma surrounds high yield and perhaps this should be reconsidered. High-yield credit is not a generic asset class, rather a diverse universe with wide-ranging risk and reward characteristics. For example one of our funds breaks down the high-yield component into three categories:

- One third held in the form of short-dated ‘cushion’ bonds. These have a short maturity and offer protection in a falling market due to the pull to redemption.
- Another third held in the form of senior secured debt. These offer substantial protection for the investor in the event of default.
- The last component held in traditional high yield. Even these, however, are extremely robust, as investors can focus on issuers with strong cash flows and diverse income streams.

In the present benign economic environment, event risk associated with investment grade M&A/LBO activity is far more of a threat than a marked increase in high-yield credit defaults. Corporate news flow remains positive, and if defaults were about to pick up, there would be plenty of warning. We believe, new high-yield issues and highly-levered issues should be generally avoided, and industries such as autos, airlines and packaging don't make it onto the radar.

This might be acting in a fairly contrarian manner when compared with the rest of the market. There are many fashionable areas of the high-yield space that are simply not proven or too risky to suit this mandate.

Many companies are anxious to price deals in a rising interest rate environment. Due to the popularity of the asset class, high-yield credit spreads are compressed, and companies are using this to their advantage by raising cheap finance, rather than issuing equity.

However this is no need to cry out for new deals, instead it is possible to stick with older issues that are tested and not opportunistic in their nature. Of course there are certain new issues that are attractive, for instance Tele Denmark was recently quite attractive. Although it was around five times levered, it's a very dominant player with strong market share. It operates fixed line, mobile and broadband businesses and has done so very successfully for some time. Unusually, the company's strategy did not change post issuance; it simply decided to lever up its balance sheet.

So what are we as fixed income investors considering going forward?

- Interest rate risk, LBO/M&A risk, and default risk; these are viewed as around 60 percent, 20 percent and 20 percent of the overall threat to credit markets, respectively.
- Whether the Fed will raise rates again in June, and if so how long they will go on pause to monitor the effects of existing policy.
- With US unemployment still low, and the likelihood of a soft landing of the housing market (as witnessed in the UK), the slowing of US growth ought not to be dramatic.
- A preference for high-yield industrials and investment-grade financials, and an aversion to industries with high input costs.

Until directional market behaviour re-emerges, it might be advisable to patiently maintain a blended approach, re-establishing some short-duration positions throughout the uncertainty. Long-duration positions will not be a focus until this uncertainty is resolved. A portfolio's duration should be paired back, the manager's search for yield, bottom-up security selection takes priority and, in this case, they should await a resolution to US interest rate uncertainty before incorporating a trend approach.

When investors think of high-yield credit, they tend to think of high risk and equity-like behaviour. This is true for part of the sector. However, high-yield credit doesn't suffer from the vulnerability to LBO and M&A risk that investment-grade credit does. On top of this, high yield holdings within a portfolio should be backed by a majority low-beta deals. High-yield credit also has around half the interest rate sensitivity of investment grade credit.
Managers who followed the above would have seen neutral performance in May, which given the context would have been satisfactory. The blended asset-allocation strategy would have proved to be safe haven money throughout the turmoil.

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