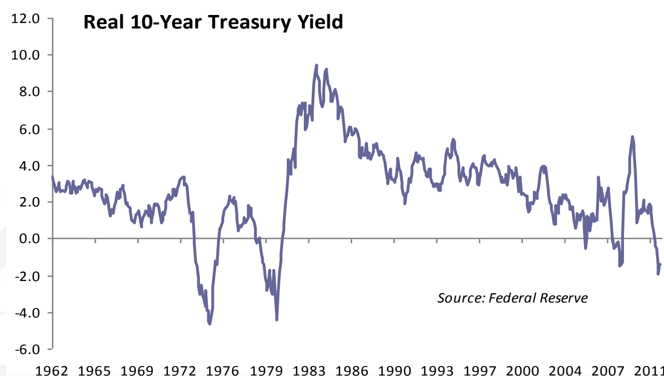
The Case for Short Duration High Yield

May 29, 2012

Valuations in the domestic high yield market appear stretched and we are concerned that opportunities for incremental return are fewer over a near term horizon. In this article we provide an analysis of the structure of the high yield market and a rationale for investing in specific short duration and callable high yield bonds which offer investors a better risk/reward trade-off in the current environment.

Following the Financial Crisis of 2008, the Federal Reserve implemented extreme monetary policies that were designed to protect the banking system, stimulate economic growth and keep the capital markets functioning. One of the intended consequences was that we have the lowest level of interest rates in economic history. This has allowed corporations that can access the capital markets the ability to refinance their debt at lower rates, therefore helping to cut interest expense and improving operating margins.

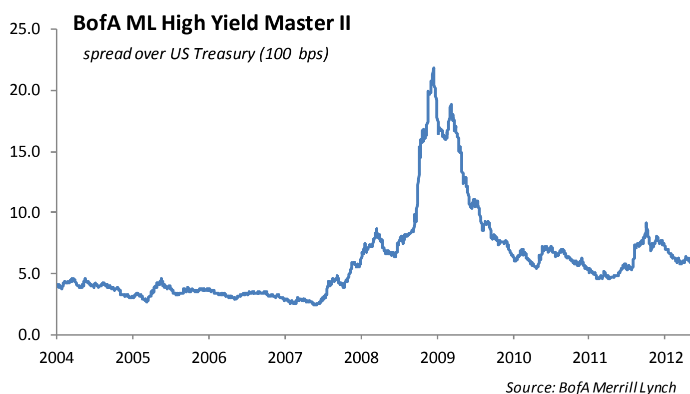
With interest rates on the ten year US Treasury note near 1.75% and spreads over US Treasuries for both investment grade and non-investment grade credits extremely tight, yields on corporate bonds of all sectors are low. For example, a recent issue of Kellogg's 10 year notes came to market at a spread of +145 over Treasury yields earning a yield of 3.23% for investors. One result of the Federal Reserve's liquidity policies is that domestic companies are now operating at their lowest cost of capital in history.



As investors searched the landscape for yield over the past year, the high yield corporate sector has proven to be an excellent opportunity. High yield bonds offer investors a unique blend of income and price appreciation and are often considered less sensitive to changes in interest rates. As a result, high yield bonds often outperform investment grade bonds in periods of rising interest rates.

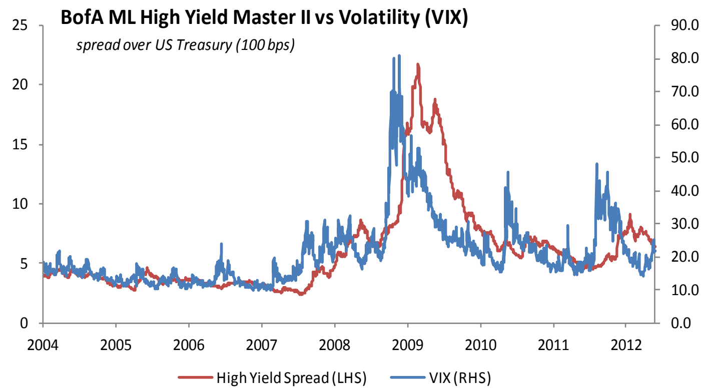
Structure of the High Yield Bond Market

The high yield market is estimated to be over $1.0 trillion in size having grown from an estimated $15 billion in 1980. In addition to the traditional buyers of high yield debt which include life insurance companies and mutual funds, hedge funds and Exchange Traded Funds are now significant buyers. Through mid May of 2012, mutual funds and Exchange Traded Funds combined reported a record amount of over $260 billion in assets according to Lipper Analytical Services.



The weighted average characteristics of the high yield market are masking some of the risks within the market. With a weighted average yield to worst of 7.23% on the Barclays High Yield Index (BCHYI) and an annualized total return of 16.5% over the past three years, it has consistently been one of the best performing asset classes according to data from Barclays Capital. However, a more in depth analysis of the high yield market reveals a different picture of the market where yields on investable high yield bonds are actually much lower and risks potentially more

damaging to investors, particularly those with passive buy and hold strategies. Volatility and spreads are positively correlated and as volatility rises (measured by the VIX Index), spreads widen. However, since the beginning of 2012, market activity shows a general decline in spreads as the VIX increases.



Source: CBOE; BofA Merrill Lynch

Breaking the index further into its components, we see a high yield market that is bifurcated by risk and yield. Roughly 42% of the BCHYI is rated in the BB category and has a yield of 5.23%, which represents a spread of 352 basis points over the ten year US Treasury note. Similarly, an additional 42% of the Index is rated in the B category with a weighted average yield to worst of 7.04%. Thus, 84% of the BCHYI has a yield to worst of only 6.14%. Further, the lower yielding portion of the market is trading so tightly to Treasury yields that the securities trade on a spread basis (instead of a dollar basis) making them more sensitive to changes in interest rates.

In some cases, yields on noninvestment grade securities are so tight that they are equivalent with investment grade issuers. For example, Ford Motor Credit Corporation, which did not take bail out money during the financial crisis, suffered a downgrade to B1/B+ in 2008. Earlier this month, the credit was rated Ba1/BB+ and the FMCC two year bonds yield 1.9%. FMCC was upgraded to investment grade at the end of May and trading levels tightened by 10 basis points as a result.

Default Rates are Lower Today

One of the consequences of the Federal Reserve's liquidity policies is that most any company that can access the public debt markets can lower their borrowing costs – regardless of quality rating. For investors, the use of high yield debt in investment strategies and asset allocation models is significantly more prevalent today than it was twenty years ago.

High yield debt has a higher degree of default risk than investment grade debt. However, we believe the monetary policies of the Federal Reserve following the Financial Crisis, which have lowered interest rates and flooded the markets with liquidity, have helped to reduce the amount of defaults over the past two years. In 2009, Moody's reported 201 companies in North America defaulted totaling $291 billion in total debt. Defaults have trended dramatically lower over the past two years. In 2010 and 2011, 46 and 25 companies respectively, defaulted representing a mere $23.3 billion and $25.5 billion in total debt defaulting.

We would caution that whenever default rates decline and issuance increases, high yield tends to underperform 18 to 24 months later. When businesses are able to leverage their balance sheets and investors accept weaker covenants, it is usually a sign of trouble. Typically, high yield investors would seek covenants that require standards for fixed charge coverage ratio, use of proceeds and limits on the amount of debt. However, recently we have seen an increase in issuance of covenant-light high yield debt deals with proceeds being used to issue dividends to shareholders or buy back stock. As bond investors, we get concerned anytime that debt is used for financial engineering which transfers value from bondholders to shareholders. As equity investors, we are concerned with excessive leverage of the company.

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Value in Short Duration High Yield Bonds

We are seeing the tell-tale signs of deterioration in the high yield market today. Those signs include a potential slowdown in global economic growth, a decline in the default rate, low yields as investors reach out the risk curve to grab yield, and willingness for investors to accept weaker covenants from issuers.

One of the most important axioms in investing is that as investors, *you can only take what the market is giving you.* Historic returns are not necessarily representative of expected returns in the asset class, and that is true today in the high yield market. Historic high yield fixed income returns are not very predictive of future returns under a mean-variance approach. A mean-variance approach to relative value or historic performance assumes a symmetric return distribution with known properties surrounding the various moments of distribution. For high yield bonds, (or investment grade bonds as well), we know that the long-term distribution of returns is not normal since the investor has limited upside potential, or slightly higher if the issue is called at a premium or the credit quality level migrates upward.

In an environment where investors are not compensated for the risk in the broader market (the market beta), we recommend investing in specific securities where an investor is compensated. We believe that the short maturity portion of the high yield market offers good relative value compared to the overall high yield market today. The strategy of maintaining a short duration protects the portfolio from a sharp rise in interest rates or a spike in volatility which may cause spreads to widen. Specific credits that we think offer good value include Arch Coal, Parker Drilling, AES, HCA and Regions Financial.

In addition, we like certain callable bonds such as the Biomet (B1/B+) 10.375% due 2017 and are callable in October of 2012. We believe the credit fundamentals of Biomet are holding up well after their $23 million settlement with the U.S. Justice Department last quarter, and expect that the company will issue new debt this summer with the proceeds going to retire its higher coupon callable debt. The bonds yield 3.98% to the call and kick to an 8.25% yield to maturity which compensates us for the call risk.

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