

A future for yield

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22nd August 2008
Credit no.49

Credit strategy: underweight high-yield bonds; anticipating an attractive entry point in late 2008 or early 2009

In the 12 months to the end of July 2008, the European High-Yield Index (EHYI) has clearly felt the pain of the credit crunch, with a total (sterling) return of -5.4%. This is no surprise considering that, at end of May 2007, the spread on the index (over underlying Bunds) had narrowed to an all-time low of 193 basis points (bps). Given that high-yield default rates over an economic cycle tend to average around 4-5%, a spread of 193bps was clearly too tight and high-yield investors were not being compensated enough for the credit risk they were taking. At the other extreme, the current spread on the index, at 834bps as of 20th August 2008, is pricing in a lot of bad news.

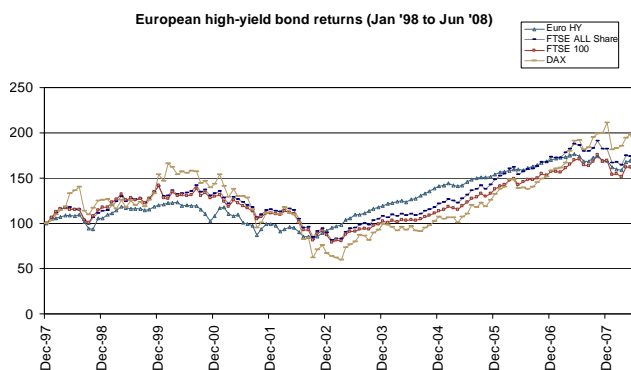
The current spread is pricing in default rates in excess of 6% for 2008, compared to a current trailing (last twelve months) default rate of around 0.7% in Europe. Although it is clear that default rates will rise from these exceptionally low levels, barring an extraordinarily sharp and sudden downturn in the eurozone and emerging Europe regions, it appears unlikely that we will witness the 6% rate implied by current spreads in either 2008 or even 2009. This is because most European high-yield companies refinanced in 2006 or early 2007 on very generous terms and were able to push back debt maturities towards the end of 2010 and beyond. However, if the capital markets remain closed for the next two years, defaults will clearly exceed their historical norm as a flood of companies looks to refinance in late 2010 and early 2011. However, if one is of the view that some semblance of normality will return to capital markets at some point within the next 2 years, European high-yield default rates may not edge up to 6% any time soon.

High-yield versus equities

A high-yield bond is effectively a hybrid between the debt and equity of a company. Similarly to an equity, it enjoys the benefit of a material upside (in terms of capital appreciation) in a favourable macroeconomic environment (in which companies are generating 'excess' cash and are therefore incentivised to refinance and take out their most expensive debt at a 'premium'). In a bear market, high yield bonds' defensive, fixed-income characteristics kick in, making them less volatile on the downside than equities. Unlike a dividend payment, the coupon on high-yield debt is not discretionary and, if the company is not able to meet its interest payment obligations, management loses control of the company to its creditors.

The graph and table below illustrate that, over the last ten and a half years, the EHYI has outperformed the FTSE 100 Index and the FTSE All-Share Index on a cumulative basis,

but it has underperformed the DAX Index. The annual equivalent return from the EHYI has been 4.8%, compared to 4.0%, 4.7% and 5.8% from the FTSE 100, FTSE All-Share and DAX indices respectively. On a risk-adjusted basis, the EHYI provides a ratio (of just below 1.5) which is well above any of the three equity indices.



	FTSE All-Share	DAX	Euro High-Yield	FTSE 100
Annual equivalent return (AER)	4.7%	5.8%	4.8%	4.0%
Standard deviation (SD)	4.0%	6.9%	3.2%	4.0%
Risk-adjusted return ratio i.e. AER/SD	1.18	0.84	1.49	1.00

All returns in chart and table are in sterling
Sources: Thomson Datastream; Bloomberg

Potential buyers of high-yield

Currently, the European high-yield market does not have the same depth as that of the US. In the US, new high-yield deals were being priced at the height of risk aversion in early March 2008 because high-yield bonds are considered in the US to be a viable alternative asset class with dedicated pools of 'real' money; rightly so considering that, since the early 1990s, US high-yield bonds have provided similar returns to the S&P 500 Index, but materially better returns on a risk-adjusted basis.

In Europe, the total size of the high-yield bond market is around €90bn (including floating rate notes and payments in kind). Precise figures are hard to determine, but it is

estimated that European real, un-levered money appetite for high-yield bonds is around €70bn currently, of which 20% is either in cash or investment grade. Apart from real money buyers, the other big participants in the market have been hedge funds, CDOs and investment banks' proprietary desks. It is almost impossible to measure the appetite of these groups, but it is safe to say that their active participation played a significant part in the tightening of high-yield spreads to roughly 190bps in May 2007. These groups will gradually return to the asset class as the pricing in by the market of a very high default rate provides an attractive entry point.

Carry

'Carry' is important for any fixed-rate instrument, but even more so for high-yield bonds when evaluating their total return potential. It is because of carry that high-yield bonds could provide attractive returns even in a rising default environment. Below, we show three scenarios of the potential total return (if money was invested today) from high-yield bonds over the next 12 months, based on the following information:

Current yield on 5-year Bunds	4%
Current credit spread on EHYI	830bps
Current European 12m trailing default rate	0.7%

Source: Bloomberg

Scenario	Default rate (%)	Govt. yield decline (bps)	Spread widening (bps)	Total return (%)
Normal recession	6	70	170	8.7
Hard recession	9	100	350	3.7
Severe recession	11	150	500	0.5

Source: Newton

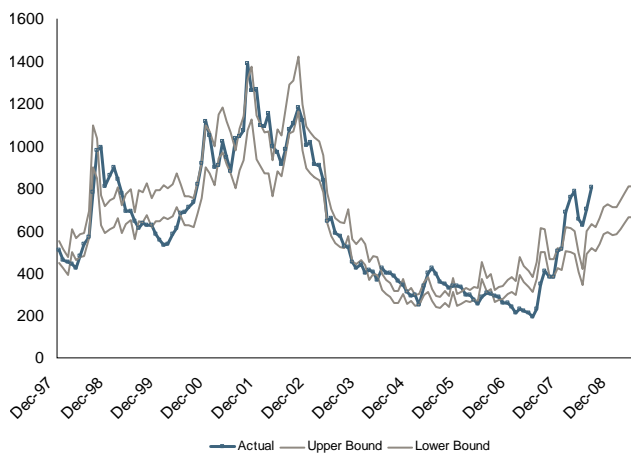
As the table illustrates, European high-yield bonds would provide a positive return in all three negative scenarios. Moreover, it is even possible to achieve double-digit returns in a widening spread environment by timing an optimal entry point into the market. For example, over the period from July 2002 (spread at 1,077 bps) to July 2008 (spread at

807 bps), European high-yield bonds provided an annual sterling return of 11.1% and, during this period, spreads ranged from about 190bps to 1,200bps. In the same period, the FTSE 100 Index provided an annual return of 8.2%. However, in a rising default environment, it is important to invest in a diversified fund to ensure that returns are not adversely impacted by event risk.

Attractive entry point in late 2008 or early 2009

As with all 'risky' asset classes, there is a tendency for the market to take extreme positions at both good times and bad times. In European high-yield, we are close to the bottom, but we do not believe we are there yet. Timing the exact entry point is more an art than a science since it depends entirely on market sentiment. However, on a fundamental basis, our model suggests that European high-yield spreads will rise to around 880bps by June 2009 (see graph below). However, spreads tend both to 'undershoot' and 'overshoot' and, given the current weak economic backdrop, we would look for the index level to be trading at a spread in excess of 950 bps, which would imply a default rate in excess of 8%, before we recommend being neutral or overweight the asset class.

European High Yield Model



Source: Newton

Important Information

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