

High Yield Investing: The Benefits of a Flexible Approach

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In this Q&A, Martin Horne, Head of Global Public Fixed Income, discusses the power of flexibility in high yield investing—especially in a volatile environment.

Against the current backdrop of rising interest rates and volatility, what are the benefits of taking a flexible approach to high yield investing?

High yield credits, like most financial markets, have certainly faced a tumultuous start to the year. Russia’s invasion of Ukraine caused extreme moves across impacted markets and pushed inflation and commodity prices to recent cycle highs. Against this backdrop, the U.S. Federal Reserve has kicked off a rate hiking cycle and Treasury yields have moved significantly higher, adversely impacting fixed rate bond markets.

While this has proved to be a challenging environment for various credit markets, a closer look reveals a high level of performance dispersion across different market segments. While fixed rate developed market (DM) high yield bonds were down -7.6%, floating rate senior secured loans with lower interest rate sensitivity profiles have performed significantly better, returning 0.0%. Beyond the more traditional segments of the market, BB rated tranches of collateralized loan obligations (CLOs) returned +0.4% while the high yield component of emerging markets (EM) corporate debt was down -9.1%.¹ For context, the investment grade credit market, which has a longer maturity profile, returned -10.6% over this period.¹

In our view, this recent volatile period underscores the importance of having the ability to look across capital structures, sectors, geographies and asset classes to not only mitigate underlying risks, but also to identify upside return potential and to uncover relative value opportunities. In particular, while credit markets tend to be highly correlated over the long term, they are impacted by bespoke market technical factors and return drivers that can cause them to outperform or underperform one another during different market conditions—and this dynamic tends to be exacerbated during periods of heightened volatility (FIGURE 1).

We would also note that returns from credit are not always associated with the markets that have the best underlying risk profile. For example, it would be logical to believe that the better underlying investment landscape will sit in the economy or industry with the strongest fundamentals, and this may be true from an equities standpoint, however, as (FIGURE 1) demonstrates, this is frequently not the case for credit investments. This is because markets are inherently poor at efficiently pricing risk and tend to over compensate in the form of additional spread in regions or areas where perceived risk is the greatest. Equally, investment managers can mitigate fundamental deficiencies by placing their investment higher in the capital structure or with security or better controls. The result can be difficult to predict unless you have a large team performing fundamental bottom up analysis.

Even within a specific market, proficient depth of expertise can help uncover compelling opportunities. For instance, while EM as a whole has witnessed sizeable drawdowns year-to-date, performance has been highly divergent across regions and sectors. While certain parts of the EM universe stand to benefit from the higher commodity prices stemming from the war in Ukraine—specifically crude producers, mining companies and soft

FIGURE 1: Relative Value Opportunities Move with Market Condition

	2015	2016	2017	2018	2019	2020	2021	YTD 2022
Global High Yield Asset Class Returns 2015 to 2022—USD Hedged²								
U.S. Loans	-0.38%	9.88%	4.25%	1.14%	8.17%	2.78%	5.40%	0.07%
U.S. HY Bonds	-5.38%	18.32%	7.31%	-2.21%	13.98%	5.92%	5.39%	-7.90%
European Loans	2.49%	6.89%	5.79%	4.09%	7.51%	4.30%	5.50%	-0.33%
European HY Bonds	1.46%	11.82%	8.28%	-0.66%	14.09%	4.50%	4.11%	-6.83%
Annual GDP Growth								
U.S.	2.7%	1.7%	2.3%	2.9%	2.3%	-3.4%	5.7%	
Eurozone	2.0%	1.9%	2.6%	1.8%	1.6%	-6.4%	5.3%	
			Highest Performance	Lowest Performance				

SOURCE: ICE BofA, Credit Suisse, JP Morgan. As of April 29, 2022. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

1. Source: ICE Bank of America; Credit Suisse; J.P. Morgan. As of April 29, 2022. Developed market (DM) high yield bonds refers to ICE BofA Non-Financial Developed Markets High Yield Constrained Index; Floating rate senior secured loans refers to CS Global Leveraged Loan Index; High yield component of emerging markets (EM) corporate debt refers to Non-Investment Grade Component of JPM CEMBI-BD Index; Investment grade credit market refers to ICE BofA Global Corporate Index.
 2. U.S. Loans refers to CS Leveraged Loan Index; U.S. HY Bonds refers to ICE BofA US Non-Financial High Yield Constrained Index; European Loans refers to CS Western European Leveraged Loan Index; European HY Bonds refers to ICE BofA European Currency Non-Financial High Yield 3% Constrained Index.

commodity exporters—others, like food retailers, will likely face cost pressures from the rise in soft commodity prices.

When it comes to allocating across credit markets, it can be difficult to deploy capital in a timely manner to take advantage of any dislocations in prices. A flexible or multi-credit approach can enable an investment manager to more efficiently pursue the most attractive relative value opportunities across a broad investable universe. The result is a more diversified approach to credit that can potentially deliver more consistent risk-adjusted returns across different market cycles relative to single-sector strategies.

How can a multi-strategy approach offer a more resilient performance profile in a volatile environment?

During periods of heightened risks, an unconstrained approach can enable an investment manager to dynamically rotate exposure toward more resilient segments of the credit markets. For instance, one way to try and mitigate credit risk is to move higher up in credit quality or more senior in the capital structure via secured assets such as senior secured loans and senior secured bonds, which have historically offered higher recovery rates in the event of a credit default or restructuring event relative to unsecured debt holdings.

Meanwhile, to manage interest rate risk, a higher allocation to floating rate products such as loans and CLOs would be more desirable—as the interest rate on a loan typically resets every three months, in line with changes in market interest rates. CLOs, which can also provide a hedge against rising rates, offer an opportunity to pick up considerable incremental yield relative to traditional bonds and loans, as well as provide the added benefits

of diversification and enhanced structural protection, albeit can come with greater mark-to-market volatility. Similarly, a greater preference for liquidity may warrant a higher allocation to bonds, which have shorter settlement cycles.

What are the advantages of being able to access multiple markets through a single strategy (and a single manager)?

Given the incredibly large size and constantly evolving nature of high yield credit markets, a single strategy solution investing across a range of markets provides investors with a governance efficient way to gain access to numerous underlying credit markets. In order to allocate capital efficiently and from a market timing standpoint, investors may also benefit from delegating the dynamic asset allocation decision making to an investment manager that has real time access to market opportunities, as well as the depth and breadth of expertise across multiple regions and asset classes. By being able to closely monitor market technicals and assess relative value opportunities, experienced active managers with holistic coverage of credit markets can be well positioned to opportunistically react to significant price moves or market events—be it in developed or emerging markets, or across fixed or floating rate credits. From an implementation standpoint, the ability to effectively source liquidity for portfolio management purposes is also essential in over-the-counter trading credit markets, and often requires dedicated high yield trading desks, strong relationships with market makers and large-scale access to deal flow activity.

In our view, investors may also benefit from partnering with a single investment manager that has the ability to create bespoke solutions to best meet client specific investment objectives and regulatory needs.

About Barings

At Barings, our Global High Yield Investment team comprises 90 investment professionals investing US\$84 billion across developed and EM high yield bonds, senior secured loans and structured credit markets.³ We also have extensive experience in the market, having managed multi-sector credit solutions since 2012. As a result, we have the ability to accurately assess and price idiosyncratic credit risk, and offer a holistic view of credit markets, which better positions us to capitalize on opportunities and navigate risks.

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3. Source: Barings. As of March 31, 2022.

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