


FUND BUYER VIEWS BY CITYWIRE

With the US Federal Reserve (Fed) finally raising interest rates, and with the Bank of England expected to follow suit at some point in 2016, the continued easy monetary policy of the European Central Bank (ECB) and Bank of Japan (BOJ) leave investors with some interesting questions ahead. But while some of the answers will not spell good news for all investment sectors, the Fed's move has left some feeling cautiously optimistic about the future of high yield.

According to Arjun Pandya, Investment Analyst at Cumberland Place, the shorter maturities and lower duration of high yield bonds sets them in good stead (despite the sector's December wobbles) to cope

with what most expect to be an extremely incremental rate rise at best.

'The forecast rate rise is only said to be marginal, and therefore we don't expect to see massive tremors – refinancing will continue as companies continue to take advantage of the low interest rate environment,' he says. 'With the ECB cutting deposit rates even further, we actually see investors going down the credit spectrum in pursuit of yield.'

Daniel Lockyer, Senior Fund Manager at Hawksmoor Investment Management, also believes a rising interest rate environment does not necessarily spell bad news for high yield bonds.

'You would usually associate a rate rise with an improving

economy, which is generally good news for high yield corporate bonds, so these companies should be doing well,' he explains.

While he remains cautious, given the role rock-bottom interest rates have played in keeping default rates low, Lockyer maintains that 'sensible' companies should come out the other side of a rate hike in one piece.

'Rising interest rates could expose companies stretched on balance sheets. But having said that, any sensible company should have taken out any debt and extended it for a long period of time before they need to refinance again,' he says.

Mark Williams, investment manager at Charteris Treasury Portfolio Managers, is looking



Alan Beaney, Investment Director,
RC Brown Investment Management



Arjun Pandya, Investment Analyst,
Cumberland Place


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beyond the immediate consequences following a rate rise towards the other potential side effects.

'One aspect that seems to have been accepted across the markets, is that regardless of how much tightening is done and at what speed it is implemented, there is a unified feeling that volatility will increase,' he says.

Following ECB president Mario Draghi's decision to extend eurozone quantitative easing, but not expand it to more than €60 billion (£42 billion) worth of asset purchases per month, UK and European markets tumbled as underwhelmed investors expressed their disappointment. For Williams, the ECB's decision illustrates the uncertain times ahead for not just high yield,

but for the wider investment universe.

'Is it possible that these bonds have already priced in the forecasted tightening? Quite possibly, but given Draghi's surprise move, the path is certainly not a clear one for any sector,' he says.

Adding diversity

Smoothing out portfolio risk is a vital objective for any money manager, but in more uncertain times that objective takes on higher importance. And for some wealth management firms, high yield has provided a much-needed dose of diversification.

'From a portfolio perspective, given that high yield bonds typically have a low correlation with investment grade sectors,

we see adding high yield bonds to our portfolio as an enhancer of diversification,' says Pandya.

Highlighting positive consumer growth and consumer spending as two factors strengthening the outlook for high yield at the moment, Pandya asserts that Cumberland Place remain cautiously optimistic around the future of the sector – particularly towards US and European high yield.

'A lot of companies have deleveraged, cash levels are at historic highs and default levels low,' he says.

Williams understands why high yield – US in particular – has proved a popular choice for investors looking to diversify their portfolios. Although, looking forward, he feels stormy waters might lie ahead for those

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continuing to diversify through junk bonds.

'About four months ago, there was a growing sentiment in the markets that the ride was about to come to an end, coinciding with the strong bull market in the US dollar price. This has had a significant impact in the sector, adding to the volatility seen in these markets,' he says.

Fixed income doubts

For Alan Beaney, investment director at RC Brown Investment Management, the lack of yield on offer has left him sceptical about investing in sub-investment grade bonds.

'In simple terms, because there is not much yield around, we believe people have actually driven down the yields on these securities to levels that do not

compensate you for the risk you are taking,' he says.

'It is similar to what happened — albeit not to the same extent — in the last financial crash: people were not pricing risk correctly.'

James Barber, head of investments at Epoch Wealth Management, displays an element of caution around fixed interest as a whole. Yet, unlike Beaney, he feels short-term opportunities within high yield are there for the taking.

'In the wider context of underweight allocations to fixed interest, we are positive on high yield,' he says. 'We have high yield exposure via a couple of different holdings, some with market duration, but also other strategies targeting much shorter maturity securities —

helping to keep the interest rate sensitivity of the strategy low.'

Manager qualities

With investors remaining cautious about high yield, and fixed income in general, finding funds with the right qualities and an astute manager has arguably never been more important.

Alan Turton, managing director at Rowley Turton, seeks flexibility from high yield bond managers, yet feels too much is made of the underlying credit quality of portfolio holdings.

'We prefer pragmatic managers with a sufficiently broad mandate to their funds, allowing them room to manoeuvre when looking to avoid some of the capital losses the sector is liable to



Alan Turton, Managing Director,
Rowley Turton



James Barber, Head of Investments,
Epoch Wealth Management


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experience,' he says. 'But it is too easy for a story to be spun about why a particular sweet spot in the market represents the optimal return.'

Lockyer echoes Turton's sentiments about the importance of flexibility, preferring smaller funds that are able to circumvent liquidity issues. But in terms of assessing the credit quality of a fund's holdings, he feels there is a particular area to be aiming for:

'Anything below CCC and you move into riskier, high-leveraged, stretched balance sheet-type companies, which are probably not worth the extra risk you are taking,' he says. 'The sweet spot is probably around the high quality end of high yield, at BB credit level.'

For Beaney, it is not the fund manager's ability to look at the here and now, but the attention to detail and foresight that matters.

'A high yield bond would not be high yield if it had good credit quality. But the question is, are people mispricing it? Is the company financially viable? It is almost like looking at it as an equity: what are its future prospects?' he explains. 'A successful high yield bond manager is a person that is very good at credit analysis or looking at these future prospects.'

Feeling the pinch?

During a year in which several multinational financial services companies have laid off staff within their fixed income teams,

the high yield sector finds itself at the centre of a seemingly contracting asset class. So is the pool of high yield bond funds set to shrink in the near future?

'I do not believe options within high yield will become constrained to a point where it will meaningfully impact our ability to select an appropriate manager,' says Barber.

'There are a number of fund houses that are well known for their fixed interest expertise, including high yield, and I cannot see these firms reducing their strategies at a point where investors are looking to maintain diversified fixed interest allocations.'

Turton says the sector could be faced with reduced investor demand, but high issuance for refinancing. Yet, these factors

may collude to be of benefit to high yield in the long run.

'This combination would see many retail funds merged into other fixed interest vehicles. The resulting increased yields will in turn become attractive, with the cycle returning to normality, but only after a painful correction,' he adds.

Although Pandya believes cuts to fixed interest teams could harm high yield in some shape or form, he sees the market contraction as a blessing in disguise, ultimately helping to separate the wheat from the chaff.

'It will definitely have an impact, but there are already too many choices. I think it is a good thing as only the strongest and the best high yield funds will survive,' he says. ■