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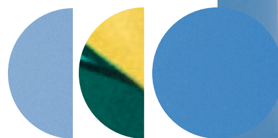
High Yield keeps its credit

60 seconds with the fund manager



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Marketing communication

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60 SECONDS WITH THE FUND MANAGER

The High Yield corporate bond segment is an asset class in its own right that offers many opportunities. Thomas Joret, Senior High Yield Fund Manager, Jean-Claude Tamvakis, Senior Fund Manager, Senior Credit Analyst High Yield, and Nicolas Jullien, CFA, Head of High Yield & Credit Arbitrage, explain how their approach seeks to optimise the potential of credit markets to generate performance.

Why High Yield corporate bonds?

High yield bonds now represent a mature asset class, a common method of financing for issuers which is now an essential element of investor portfolios. With broad diversification across sectors and maturities, High Yield bonds typically offer higher yields than Investment Grade bonds. The performance of High Yield bonds is also generally less sensitive to changes in interest rates.

However, investors must keep in mind that these bonds have a higher default rate than for investment grade issues. The rate of recovery is another important factor. Both of these elements require the support of a team of analysts dedicated to the high yield asset class.

So does investing in a portfolio of High Yield bonds today lead to outperforming fixed income markets?

The world is increasingly dominated by key trends, such as digitalization, bipolarization and decarbonization, which are profoundly transforming economic relationships and are likely to significantly disrupt financial markets. Combined with the interventions of central banks that may be pursuing policies counter to the fiscal policies of governments, these trends are a source of concern for investors and are creating volatility in the money and bond markets.

In such a context, outperformance will depend on diversification, selectivity and active management to maintain a controlled and calibrated investment risk profile.

What is your approach to extracting this alpha(1) from the High Yield market?

Our strategy is based on three pillars. First of all, we have a global view of the market, covering the two broadest markets: the United States and Europe.

In addition, we cover a wide range of instruments: High Yield(2), Investment Grade(3), fixed and floating rate, and derivatives.

The "high-yield" rating is typically assigned by a rating agency. For example, a bond or issuer must have a public rating of less than BBB- to be viewed as high/speculative status by Standard and Poor's.

(1) Alpha is often considered to represent the added value that a portfolio manager adds or subtracts from the performance of the underlying market.
(2) High yield or speculative grade bonds refer to lower credit quality when assessing an issuer's probability of default.
(3) Investment grade bonds refer to a higher credit quality (lower probability of default) assigned by a rating agency.

High yield contrasts with investment grade bonds. For example, a bond or issuer must have a rating above BBB- to carry investment grade status with Standard and Poor's. Investment grade bonds are opposed to High Yield bonds. In High Yield bonds, as well as in Investment Grade, we actively manage strong conviction-based positions via fundamental analysis, legal analysis and quantitative research. We seek to find the best opportunities via our broad market coverage and then use our specific expertise to select the best instruments accordingly (bonds/ CDS or Credit Default Swap[4]).

Finally, we seek to adopt a prudent approach by managing specific risks such as liquidity, underlying sovereign risk, tail risks, volatility and, of course, credit risk. We follow a strict sell discipline aimed at limiting losses and use asymmetric products such as hedging options. This also means favouring minimum thresholds for issues in circulation and choosing liquid issuers, rated by a public rating agency and listed on the stock exchange, so that the issue offers a CDS market and a number of market makers.

How are research and selectivity implemented in your strategies?

The selection of issuers and issues is based on rigorous fundamental research that integrates ESG (Environmental, Social and Governance) factors. The main objective for us is to identify the issuer's creditworthiness, i.e. the ability and willingness of the issuer to repay its debt and its default risk. To assess this, each issuer is analysed and assigned an internal credit rating by our team of analysts. Our in-house rating is based, among other things, on extra-financial criteria as these can have a significant impact on the issuer's ability to repay its debt, as well as its long-term viability.

We have put in place an ESG integration framework in collaboration with the ESG analyst team. Once we have identified all the risks related to an issuer, allowing us to have a complete and detailed view of their situation, we can then decide whether to invest through our conviction-based, flexible and active approach.

How can a flexible approach enhance performance?

We go beyond the traditional rating boundaries to position ourselves across the spectrum of Investment Grade and High Yield segments. There are interesting opportunities at the border between these two segments and the market can have a significant difference in perception between rising stars and fallen angels.

For issuers that change investment categories - fallen angels whose rating changes from Investment Grade to High Yield - the additional return offered following the increase in the risk premium may be an investment opportunity when the company wishes to return to Investment Grade and becomes a rising star after repositioning its operational profile.

Our strategy is therefore not exclusively focused on High Yield; it can also include Investment Grade bonds. In addition, we dynamically manage overall duration in order to adapt to different market environments.

What are the essential skills needed to implement your strategy?

Our in-house legal expertise in contracts, covenants, and corporate structures is just as important as our credit market expertise. Sometimes, the real risk lies not in the credit markets but, on a deeper level, in the details of the contractual provisions.

It is also crucial to monitor the main drivers of performance with controlled risk management, particularly in times of uncertainty. A disciplined strategy and strong technical skills are significant assets but cannot replace experience.

(4) A CDS is a swap between two counterparties, in which one buys and the other sells the credit protection referring on an issuer (a company or a country). In exchange for an agreed payment, the buyer of the protection will obtain compensation in the event of default by the issuer over a specified period of time. A CDS can be viewed as an insurance contract against the default of an issuer. The CDS contract is triggered when a credit event occurs, requiring the seller to compensate the buyer for the unrecovered amount of the issuer.

In addition, ESG integration in this strategy, i.e. understanding the long-term business model, is also a differentiating factor.

A pioneer in European High Yield bond management with more than two decades of innovation since the creation of the Euro, our team has expanded as this market develops. It combines a number of skills and experience, ranging from own proprietary accounts to long/short equities and leveraged finance. Our flexible and innovative approach aims to create long-term value through a variety of Long Only and absolute return strategies and an ESG approach.

The main risks associated with the strategy are:

- **Risk of capital loss**
- **ESG investment risk**
- **Sustainability Risk**
- **Equity risk**
- **Interest rate risk**
- **Credit risk**
- **Currency risk**
- **Liquidity risk**
- **Risk related to derivative financial instruments**
- **Counterparty risk**
- **Volatility risk**
- **Emerging market risk**
- **External factors risk**

ESG Investment Risk: The non-financial objectives presented in this document are based upon the realization of assumptions made by Candriam. These assumptions are made according to Candriam's ESG rating models, the implementation of which necessitates access to various quantitative as well as qualitative data, depending on the sector and the exact activities of a given company. The availability, the quality and the reliability of these data can vary, and therefore can affect Candriam's ESG ratings. For more information on ESG investment risk, please refer to the Transparency Codes, or the prospectus if a fund.

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