

GLOBAL HIGH YIELD: REMOVING THE ALPHA HANDCUFFS

Investors increasingly recognise the benefits of global approaches to mainstream asset classes. High yield bonds, however, as a less-frequented asset class, are often approached on a piecemeal, regional basis. We argue that a global approach to high yield offers improved potential for diversification and clear advantages for investors seeking a wider range of alpha sources.



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Joined investment industry in 1990.

Main responsibilities

Todd joined Aviva Investors North America in 2008. He is responsible for overseeing all high yield strategies and managing the high yield business.

Experience and qualifications

Todd has more than 20 years of investment management industry experience.

Prior to joining the firm, Todd was senior Managing director and global head of high yield for ABN AMRO Asset Management, Inc.

Todd earned his bachelor's degree in Business management from Central College and his master of business administration degree from Drake University. He holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the CFA Society of Chicago.

Background

Since its inception, the high yield bond market has been dominated by US company issuance denominated in US dollars (USD). While non-investment grade rated bonds have been in existence since the establishment of the major rating agencies in the early 20th century, the high yield bond market really began in the late-1980s with the emergence of investment bank Drexel Burnham Lambert, which specialised in the issuance and trading of high yield bonds. The market experienced an uptick in defaults in 1990 to 1991 as the US economy fell into recession and many corporate balance sheets were too leveraged to survive.

The European high yield bond market also had a shaky start when it came into existence after the advent of the euro in 1999. With nearly two-thirds of the European market concentrated in the telecommunications, media, and technology (TMT) industries during the period 1999 to 2002, the market initially lacked diversification, and many of these highly speculative TMT companies eventually defaulted, restructured, or liquidated.

Today, the US and the European high yield bond markets are relatively well diversified by industry, and default rates are fairly consistent across both regions. While trading liquidity is significantly lower among European high yield bonds, today the European market accounts for approximately 18 per cent of the US\$1.1 trillion global high yield bond market. The US high yield market accounts for the lion's share of the remainder, comprising around 81 per cent, while a rump of largely USD-denominated Asian high yield issues accounts for the remaining one per cent.

European market growth has principally been driven by European company issuance, although non-European company issuance of euro and sterling denominated bonds, mainly from the US, has also been a source of growth. Given the similarity of performance drivers between the US and European high yield bond markets, and the amount of multi-currency issuance, it has become possible and advisable to adopt a global approach to managing high yield bonds.

Indeed, managing a global high yield mandate not only provides an unconstrained investment universe but also offers a number of other benefits related to removing the manager's "alpha handcuffs."

Diversification

A manager who is given the freedom to pursue a global mandate will naturally be presented with a more diverse selection of companies to choose from and, potentially, more alpha sources from which to deliver returns. Furthermore, this increase in the opportunity set can be achieved with little additional risk or costs, given that hard currencies can be hedged back to an investor's base currency at a relatively low expense.

Indeed, we believe that European high yield managers should be part of a global high yield strategy in order to achieve adequate diversification and have access to a workable range of alpha sources. It is common knowledge in the high yield bond marketplace that it takes diversification to transform the asymmetrical return profile of a single high yield bond, in which downside potential far exceeds upside potential, into a more bell-shaped return profile. Most high yield managers hold at a minimum 75 to 100 names to achieve diversification, and many hold considerably more. Furthermore, the largest positions in high yield portfolios typically have weightings of around two to three per cent. If we consider that the European high yield bond market has approximately 307 issuers, many of which trade infrequently, and that it takes at least 100 names to achieve acceptable diversification, then it follows that diversifying a European high yield bond portfolio and finding a varied selection of reliable alpha sources is a tall order.

An additional potential dilemma for European high yield managers is the effect of fallen angels on market diversification. Following the financial crisis of 2008-9, the European banking sector experienced a period of downgrades to non-investment grade, with the result that high yield banks now account for approximately 12 per cent of the European high yield bond market¹. While constructing high yield portfolios relative to index weightings is obviously

not recommended, this increase in the exposure of the European market to banks does reduce the diversity of the investment universe. By contrast, banks account for just 1.9 per cent of the US high yield market.

While it is possible to prudently manage a European high yield portfolio distinct and separate from a US high yield portfolio, investors should be aware of the limitations of this approach, especially compared to a global approach to managing high yield bonds. The efficient frontier in Figure 1 illustrates how a USD currency hedged investor can reap long-term diversification benefits by adopting a global approach to high yield, or adding an exposure to European high yield bonds to a US high yield portfolio.

A 12 per cent allocation to European high yield within a global high yield portfolio would have created a superior Sharpe Ratio compared to a portfolio that was 100 per cent invested in US high yield.

US high yield and European high yield: allocation as an additional alpha source

Between January 1, 2011 and August 31, 2011 the total return from the European high yield bond market (USD hedged) has been -3.3 per cent, while the US high yield bond market has delivered +1.9 per cent. This 520 basis point difference has been driven mainly by macroeconomic and political influences that are specific to the European region. The sovereign debt crises of Greece, Ireland, Italy, Spain and Portugal and the potential for contagion in the wider European banking sector, which many argue needs to recapitalise,

have been major factors leading to the re-pricing of risk specific to European sovereign and high yield corporate credits. In this situation, an unconstrained global high yield bond manager can elect to emphasise US high yield and de-emphasise European high yield. This offers the potential to secure additional alpha by employing a level of flexibility which is not available to investors that have separate and static allocations to US high yield and European high yield strategies. If a manager is constrained to managing a European high yield portfolio, the alpha source of selecting European relative to US high yield is non-existent.

Capturing inefficiencies between regions

One clear advantage of managing a global high yield mandate is capturing the capital structure inefficiencies between multi-currency tranches of the same issuer. This allows the manager to increase yield on a currency-hedged basis without increasing credit risk, or default probability. Because the European high yield market is still relatively young and illiquid, and has an investor base that is more tactical in outlook than US high yield investors, the European market has historically been more volatile.

This can create opportunities to own the euro and sterling denominated bonds rather than the USD denominated bonds of US companies after a sell-off in the European high yield bond market. Additionally, a global approach is an efficient approach because it allows the manager to focus on the most attractive

2. August 2011 was a very volatile month as a result of Standard & Poor's downgrade of the US government's triple-A credit rating on 5 August, continued worries over southern European sovereign debt and heightened concerns of a US double-dip recession materialising.

Figure 1. Blending US and European High Yield

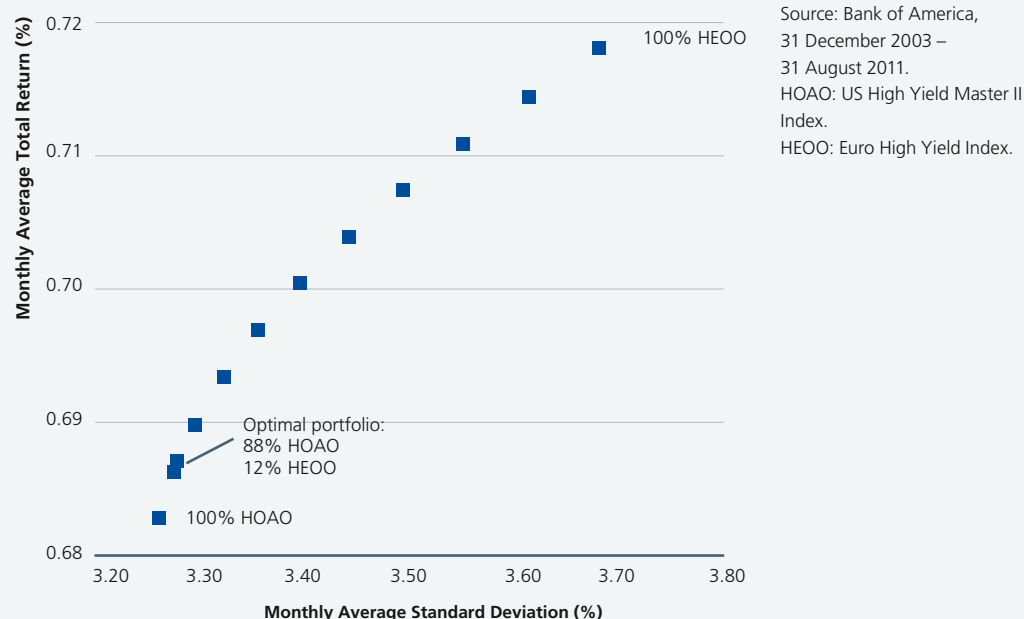


Table 1. Bombardier and Lyondell high yield bonds with the euro denominated bonds hedged to USD

Bombardier 6 1/8 2021 (Euro)			Bombardier 7 3/4 2020 (\$)		
Date	Price	YTW*	Date	Price	YTW
10/21/2010**	99.04	6.22%	10/21/2010	109.75	6.36%
8/31/2011	91.00	7.40%	8/31/2011	109.25	6.33%

Lyondell 8 2017 (Euro)			Lyondell 8 2017 (\$)		
Date	Price	YTW*	Date	Price	YTW
3/31/2011	109.50	5.63%	3/31/2011	110.25	5.68%
8/31/2011	106.00	6.30%	8/31/2011	110.75	4.71%

* YTW is currency hedged back to \$ using forward curve.
 ** New issue date for Euro tranche.

Source: Bloomberg: BAML Fixed Pricing

part of a company's multi-currency capital structure. If an investor has separate US and European high yield mandates, the combined portfolios may own the same issuer but in both USD and euro denominations, rather than focusing on the most attractive currency. A couple of examples illustrate this point.

Table 1 portrays Bombardier and Lyondell high yield bonds with the euro denominated bonds hedged to USD. Bombardier is a Canadian-based aircraft manufacturer and Lyondell is a global petro-chemical company. Bombardier has USD and euro denominated bonds. On October 21, 2010, Bombardier issued euro denominated bonds with a 6.125 per cent coupon and a 2021 maturity. This provided a 6.22 per cent yield on a USD hedged basis, while the USD denominated Bombardier 7.75 per cent coupon bonds, maturing in 2020, had a 6.36 per cent yield. The two similar bonds were priced efficiently at the time.

However, by August 31, 2011² the same euro denominated bond yielded 7.40 per cent (USD hedged), the bond's price having fallen by eight basis points since issuance, while the Bombardier's USD issue had remained stable, yielding 6.33 per cent. While market sentiment in the European market may continue to cause underperformance relative to the US market, Bombardier's dual currency issuance provides an opportunity for alpha seekers to achieve higher yields without an increase in credit risk.

The Lyondell bonds present a similar opportunity. On March 31, 2011, the euro denominated Lyondell eight per

cent coupon bonds maturing in 2017 were yielding 5.63 per cent USD hedged. This compared to the USD denominated Lyondell eight per cent coupon bonds maturing in 2017 at practically the same yield of 5.68 per cent. However, on August 31, 2011, the euro denominated bonds had fallen in price and provided a yield of 6.30 per cent (USD hedged), while the USD Lyondell bonds had rallied in price and provided a yield of 4.71 per cent. Capturing this yield pick-up of 159 basis points with the same coupon and maturity on a currency hedged basis can be a valuable alpha source for a global high yield manager.

Portfolio construction at the global portfolio level

A global approach to high yield bonds offers significant portfolio construction benefits, but the ability to reap these benefits in full depends to some degree on how the investment approach is structured and how investment teams are incentivised. There are two main methods of managing global high yield; we will call one the "sleeved approach" and the other the "coordinated approach." Both methods utilise local market expertise, research and execution of trades.

In the sleeved approach the portfolio is divided into two portfolios, a US portion and a European portion. The allocation between the two markets is not necessarily static, and so regional allocation can be an alpha source. However, accessing the alpha sources available from multi-currency issuance by the same issuer becomes more problematic, as do overall portfolio construction themes. Sleeved US

portfolio managers construct their portion independently of their European counterparts. This is acceptable in a multi-asset class framework, but when managing a single asset class, it is important to have everyone rowing in the same direction. For example, consider the implications of a European portfolio manager adopting a “risk on” portfolio while the US portfolio manager holds a “risk off” portfolio, or the European portfolio manager builds positions of three per cent, while the largest US position is two per cent. These disconnects would be a non-starter for any prudent consultant or institutional client when it comes to manager selection.

In the coordinated approach, the global mandate benefits from the same local expertise and execution within respective regional markets as in the sleeved approach. However, bond selection is compared across regions, industries and currencies. For example, a chemical company in the US is compared

with the global universe of chemical companies rather than purely within its regional universe. This requires constant communication between the US and European portfolio managers and also with regional research teams in order to emphasise industry and company expertise on a global scale while maintaining local intelligence. The portfolio is constructed with a holistic view of the global market, evaluating the opportunities across the entire universe.

Incentives and team behaviour

It is of critical importance to ensure that an investment team’s incentives are aligned with their clients’ objectives. In the sleeved approach, it is common for a portion of each portfolio manager’s remuneration to be tied to the performance of their sleeve. While this methodology emphasises direct accountability, it does not align the manager’s incentives directly with the client’s objective. A sleeve may perform well, but if the overall portfolio does not perform well, the investor may be at risk

because the investment team did not focus on the client's overall objective at the portfolio level.

By contrast, the coordinated approach emphasises a team-based approach that is fully aligned with the client's objective. All the portfolio managers in the US and Europe have the same objective – the performance of the overall portfolio. While it could be argued that this incentive methodology makes individual managers less accountable, it can also be argued that the managers are more accountable to the client as a team. A team-based, coordinated approach to managing global high yield bonds produces the right investment team behaviour when incentives are aligned at the portfolio level.

Key points

- After problematic early histories, the European and US high yield markets are well-diversified by industry and default rates are consistent across both regions.
- The similarity of performance drivers in the US and Europe aids the adoption of a global approach to high yield. Having an allocation of European high yield within a global high yield portfolio has improved risk-adjusted returns.
- Adopting a global approach to high yield naturally increases the size of the investment universe, and enables investors to benefit from tactical and strategic allocations between regions.
- The increase in multi-currency issuance by individual issuers allows investors to focus on the most attractive area of an issuer's capital structure, and potentially increase yield with no additional credit risk. Hard currencies can be hedged back into the investor's base currency at relatively low cost.
- A coordinated approach to global high bonds emphasises the performance objectives of the overall high yield portfolio, and aligns clients' interests directly with those of the portfolio managers.

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