INVESTMENTS | SEP 05, 2024

A new approach to the high yield market – Kaleidoscope eyes to alter patterns and open new opportunities for offshore investors

Stephen Hagan, Managing Partner at InCadense and Rafael Tovar, Head of US Offshore & LatAm Distribution at AXA Investment Managers, have a look at the US high yield market and what to look at when selecting a manager

The trends shaping investors outside the U.S. include diversification from their home market, demand for yield, and greater transparency. U.S. High-Yield Bonds via a separately managed account could check all these boxes. Successful investment in high-yield bonds requires an experienced manager who understands market nuances and liquidity profiles, particularly in a low-interest-rate environment where such bonds become more attractive. To uncover these opportunities, an offshore investor should consider using a Venn diagram, commonly employed in math and science to visually organize information and identify patterns, highlighting crowded areas and unique opportunities for investors.

U.S. High-Yield Bonds, the first of the overlapping circles, are also known as junk bonds. Rated as BB or lower by credit agencies such as Standard & Poor's, Moody's and Fitch, these bonds offer higher interest rates due to their higher risk of default when compared to investment grade bonds. "Investors are attracted to high-yield bonds despite the increased risk because of their potential for higher returns, which can enhance income and diversify a portfolio," says Stephen Hagan. In today's economy, better-than-expected growth is keeping default rates low and further compressing the spreads of both investment-grade and high-yield corporate bonds. The absolute level of yield in the high-yield market remains attractive, though the yield spread against U.S. Treasuries is historically low.

"B/BB bonds could provide investors with a sweet spot in the high-yield space as they can offer attractive potential returns compared to investment-grade bonds while avoiding the lowest-rated CCC bonds, which can potentially carry a much higher default risk," notes Rafael Tovar. "This cohort of bonds offers a different risk-return profile compared to equities and investment-grade bonds, helping to balance overall portfolio risk," Tovar continues. They are typically USD-denominated and generally represent the upper band of quality within the high-yield space. Lastly, the B/BB segment is typically less volatile than the rest of the high-yield space and offers investors broad exposure across market sectors.

Within high yield, there are a variety of options, from fully registered bonds to 144A bonds, which are securities issued under Rule 144A of the U.S. Securities Act of 1933. These provide a safe harbor from the registration requirements but limit the resale of such securities to qualified institutional buyers. Lastly, Regulation S securities refer to securities offered and sold outside the United States without being registered with the U.S. Securities and Exchange Commission. Unlike the 144A market, this segment does not have the qualified institutional buyer requirement.

Regulation S Bonds represent the second circle and can only be purchased by non-U.S. investors. This cohort of bonds, with a unique investor base, can exhibit liquidity and pricing dynamics that create opportunities not available in the broader market. According to data from SIFMA, after a slow 2022, high-yield bond issuance rebounded in 2023, and year-to-date (June 2024) seems to continue along that path. Approximately 75% of all high-yield issuances are via 144A, with

Regulation S issuance being a subset of that. While there is not always a one-to-one relationship between 144A and Regulation S bonds, there is an ample universe of opportunities to select from.

Tovar points out an often-overlooked consideration when deciding which Regulation S bonds to invest in. “Liquidity is an important factor and requires monitoring, as it can change with market conditions and sentiment.” Reporting on liquidity has improved dramatically, and providing market data helps investors understand current trading conditions. From a macro perspective, several positive factors should be considered, such as recent easing in financial conditions, the concentration of B/BB ratings in various indices, and the potential for U.S. Federal Reserve easing. Market commentators suggest any downgrades should be low and manageable, and the current environment provides an opportunity to leverage research capabilities to avoid surprises.

The third circle of our Venn diagram is the **Investment Manager** possessing a strong understanding of both the high-yield market and Regulation S market, which is critical for success. They need to understand the nuances of the high-yield market and the liquidity profile of the market. Navigating the current investment landscape requires careful consideration of both macro-level factors and how each asset class contributes to a diversified portfolio from a risk and return perspective. Current research trends indicate favorable conditions for B/BB bonds, suggesting potential opportunities and improvements for investors willing to engage in thorough analysis and strategic decision-making.

A lower interest rate environment going forward strengthens the case for high yield bonds. “The high-yield market, by its very nature, has more risks and a manager must possess the necessary trading acumen to balance these risks in a dynamic environment” says Hagan. The Venn diagram highlights the high-yield market that is of interest, and the Regulation S market provides a unique opportunity for offshore investors. Hagan closes out by adding “Executing against this opportunity is the investment manager, who can provide significant value through a well-structured investment approach. Engaging an experienced investment manager is critical because while the idea appears promising, it also carries inherent risk.” We should all be reminded of the long-standing sentiment, that investing, akin to life, “happens to you while busy making other plans.”

https://citywire.com/americas/news/a-new-approach-to-the-high-yield-market-kaleidoscope-eyes-to-alter-patterns-and-open-new-opportunities-for-offshore-investors/a2449457