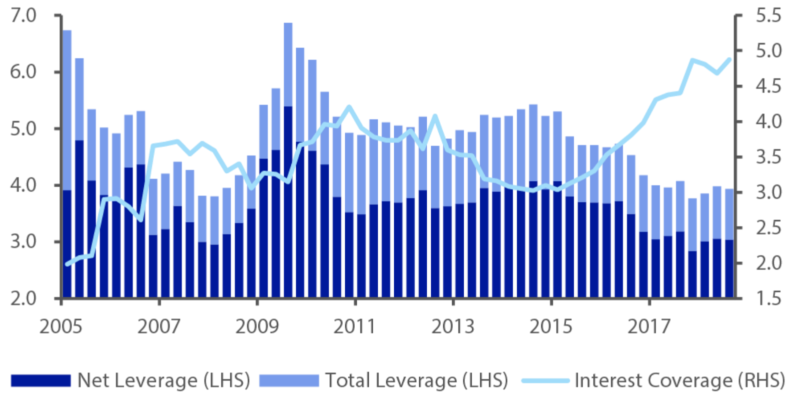
Maximize your Yield

DPAM's high income experts, Bernard Lalière and Marc Leemans, share their investment insights on the risks and opportunities of the asset class and on market conditions at the onset of a new year.

How healthy is the EUR-denominated high yield market?

While we are in the late innings of the cycle, especially in the US, corporate balance sheets are far from stretched, even though mergers & acquisitions, leveraged buy-outs, etc. have increased. Actually, **leverage levels of European issuers remain close to historical lows**. US issuers are more leveraged, but the US companies that tap the EUR market are the better rated ones.

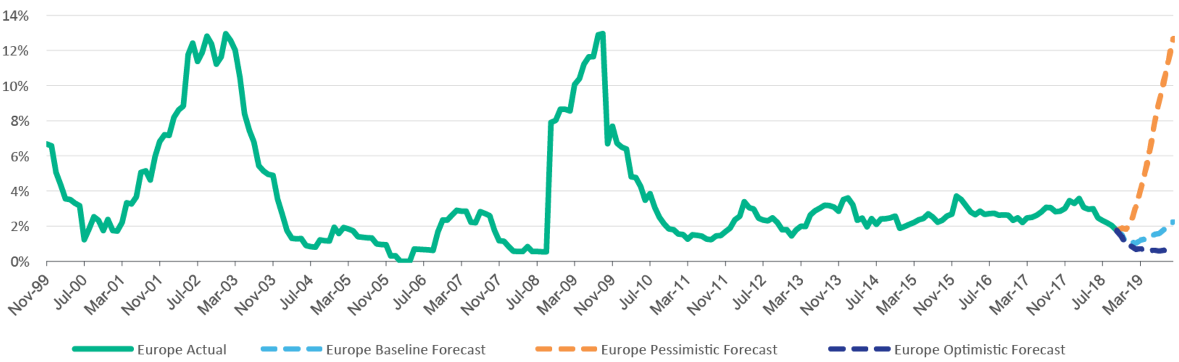
Leverage of European high yield companies is close to historical lows



Source: Deutsche Bank, December 2018

Overall, despite signs of rising company-specific credit risk, **the expected default rate is still very low** at around 2% per year (Moody's) and with spreads of around 450 basis points, investors are well compensated for the risk.

Europe high yield default rates (actual and forecast)



Source: Moody's, November 2018

Also of note, the **valuation** of the EUR market is now **attractive** both historically and compared to the USD market.

The valuation of the EUR high yield market is more attractive versus the US

Source: Bloomberg, DPAM, 12/03/2013-12/03/2018
Note: EUR HY= Bloombrg Barclays European High Yield, 3%-capped, ex-financials, Index;
US HY= Bloomberg Barclays US Corporate High Yield Index.

Meanwhile, from a supply/demand standpoint, the expansion of the direct loan market in parallel to high yield has reduced issuance in our asset class, but **investor demand remains elevated** amid rising, but still very low rates.

According to anecdotal evidence, inflows, especially from strategic rather than tactical investors, are also coming back after receding for over a year due to high valuations. Two negative years in a row would be a historical rarity.

All is not well in the world though… the first quarter of 2019 in particular seems fraught with 'top-down' danger?

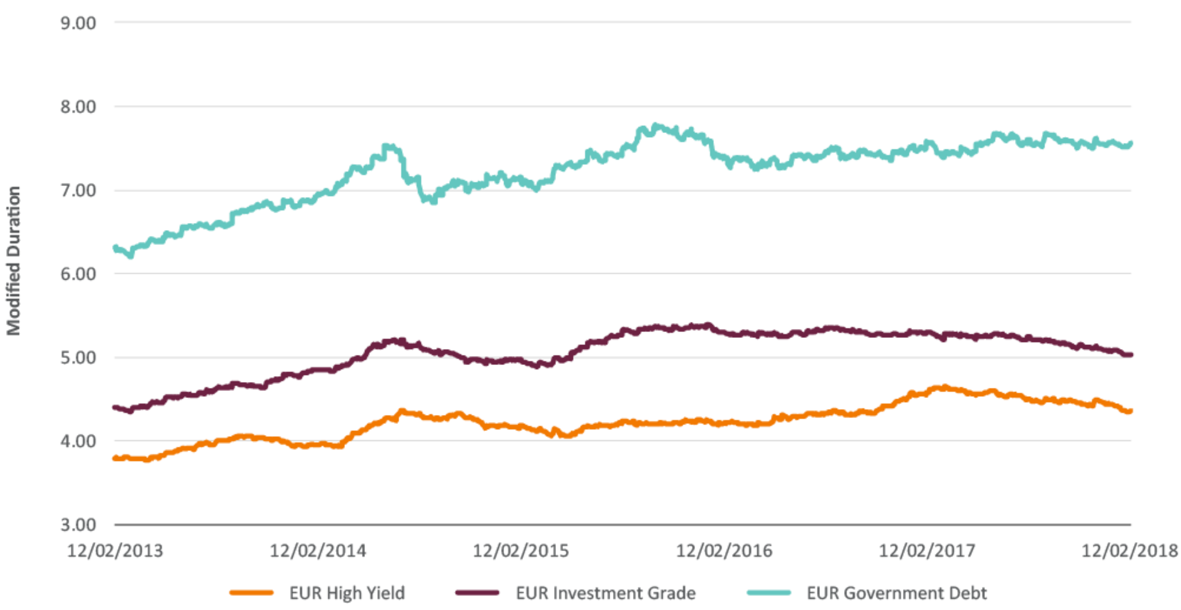
Volatility is certainly in the cards for 2019. That being said, that is **not a rare phenomenon** for high yield debt and for dedicated fund managers. Investors who stay put for a period that coincides with the duration of our fund—about four years currently—should be fine.

We are facing different types of risk at the moment and they require different types of responses.

First, we must mention signs of a global economic slowdown—though let us stress that this does not mean that the economy will stop growing, only that it will not expand at such a fast clip. Separately, the Fed is raising rates, while quantitative easing will end in the Eurozone.

These are not really new developments and in our view, these **risks are already priced in** the market. We would even go further regarding the monetary tightening: this will likely create opportunities. Historically, **high yield markets do well when central banks normalize policy** by hiking rates. On the one hand, this is a sign that the economy is doing OK and therefore, well-managed companies generate cash flow and repay their debt. On the other hand, companies with a high yield rating tend to issue bonds with a shorter maturity than investment grade companies and thus are less sensitive to rising rates. Also, the high coupon can cushion the impact of possible price declines.

High yield debt has a lower duration/sensitivity to interest rates



Source: DPAM, 30/11/2013-04/12/2018

Another top-down risk to mention is the political uncertainty surrounding the global trade war and closer to us, Brexit and the Italian budget. While it is impossible to be totally immune to these factors, we have more than one trick up our sleeves to face this: active management, flexible risk allocation and as always, bottom up analysis to avoid companies whose ability to service their debt may be meaningfully impacted.

Thus, we have **reduced our exposure to the UK and Italy** and as much as possible, we focus on companies like Italy's International Gaming Technology with mostly global activities rather than those that are domestic-oriented and therefore vulnerable to unfavorable local conditions.

Are there risks that are more specific to the high income market?

Our investment universe could swell in case of a massive arrival of fallen angels, that is, investment grade issuers that are downgraded to high yield. Such a phenomenon, which would inflate supply, is more typical of recessions. So far this year, only Spanish supermarket chain Dia has known that fate and we are staying away due to a lack of visibility. However, **fallen angels can also be a source of opportunity**, like Anglo American in 2016, a bet that worked out well for us.

Meanwhile, the EUR market could fall in sympathy in case the richly-valued US high yield market corrects lower and there is the risk linked to a drop in oil prices—keep in mind that the energy sector is a big weight in the US high yield market. Finally, there is rising company-specific credit risk. We would say that for these risks, **a conservative strategy focused on undervalued quality issuers** can help mitigate return fluctuations.

So what do you do ahead of what is likely to be a more unpredictable period for the market? And what about longer-term disruptive trends such as e-commerce vs. traditional retail, etc.?

First of all, you have to know that the **EUR high income market has a 'built-in' defensive bias**: close to 25% of reference index, the Bloomberg Barclays European High Yield, 3%-capped, ex-financials, Index, is made out of telecom issuers, which are not very cyclical. The next sector, autos with about 10%, is more cyclical, but we have underweighted it for a while already in light of declining car registrations.

Also, we can **adjust portfolio construction**—increasing the weight of our 'cash cows' which are companies with ample ability to pay high and stable income. In addition, we can modify exposure to the various grades of credit quality. When the general outlook improved in the summer, we had raised exposure to attractively valued B and CCC issuers. Now, we are migrating up the rating scale a bit, buying BB debt and taking profits on B issuers, which have done really well.

Most important however, we **stick to our research-driven bottom-up process**. We do look at sector cyclicality as well as long-term disruptive trends, but they are one among many factors we look at when we conduct analysis. Normally, our process naturally leads us away from disrupted business models —by the way, retail is currently underweighted—, as the change in trends can be detected at the top-down and bottom-up levels.

Any specific examples?

The third-quarter earnings season illustrates how critical our process is. While corporate results have been in growth mode since 2016, we are now seeing some disappointments in earnings. As the saying goes, 'A rising tide lifts all boats and only when the tide goes out do you discover those who have been swimming naked'

Nyrstar, Astaldi, Moby or Obrascon seem to belong to the latter category. This summer, Nyrstar (which we had avoided at the time) had had operational issues, which led to declining cash from operations and higher leverage. Management was stuck in 'wait-and-see' mode and hoped for improvements, which failed to materialize, as seen when it released results.

In contrast, the likes of Ardagh, Verallia or Warner Media Group did well this season. They have a clear business strategy and their level of leverage is sustainable when one factors in the prospects of their underlying business.

It is all about selecting 'elite yield'—undervalued companies with the best fundamental outlook—, building an overweight position in these conviction names and capturing their rate premia, while avoiding issuers that have weak business models and balance sheets. **Our process was tested more** than once, with for example turbulent market conditions in 2013 ('US Taper Tantrum'), 2015 (emerging market and commodities rout) and 2018, but we still outperformed.

Would you share one last nugget of wisdom as successful seasoned managers?

Sticking to your process does not mean staying stuck or being stubborn.

If we expect an upgrade, and the data do not confirm it, we sell and look for opportunities elsewhere. For example, in 2017, Spanish construction company Obrascon had sold a large concession business in Mexico for over EUR2 billion. It became net cash positive, and with debt reimbursements due in 2019, 2022 and 2023, we expected it to use its cash to reduce leverage and we built an overweight position. The company's message continued to be positive until early 2018 and then it unexpectedly posted a loss. We moved to 'neutral', because it still had the cash and if it called its bonds, we would not lose any money nor would we trail the benchmark. Then, the newly appointed CEO stated that he would take his time to reexamine the company's capital structure. Amid a lack of clear decisions and visibility, we sold this year and since then, it is trading at very distressed levels.

Another example this year would be Telekom Danemark, which had done a leveraged buy-out and the data lacked clarity, so we did not own it. Then, it sold its Norway business at very high multiples and we thought that it could reduce leverage faster than anticipated, so we added it to the portfolio, a decision that later paid off handsomely.

In sum, **never fall in love with the investment case.** Sometimes, you do or don't invest for a particular reason, but you must constantly revise this as new data appear every day and you must quickly add, reduce, buy or sell if necessary. This skill, which takes years to build, is a true differentiator and a key contributing factor to our long-term outperformance.

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