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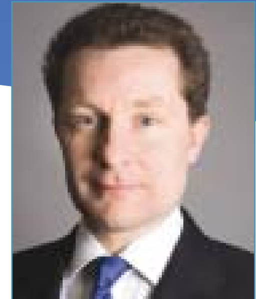
# riding high



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## Peter Harvey, Head of Credit at Cazenove Capital and Manager of the Cazenove Strategic Bond Fund, explains how high yield is achieved in corporate bond funds.

In September 2008, the Investment Management Association formed the Sterling High Yield peer group, a specialist corporate bond sector. The £4 billion peer group currently consists of twenty investment funds, most of which now offer a yield above 10% per annum.

But how do the funds generate income and pay out dividends well above current interest rates? The answer is by purchasing corporate debt in four main categories: financials, fallen angels, leveraged buy-outs and emerging markets.

### financials

In the dull world of bonds, the banking sector offers a spot of excitement; after all, it was a bank that generated the largest default in 2008. Post Lehman, many subordinated bank and insurance bonds now offer double digit yields. Some high yield bond funds use this strategy to augment income, whilst staying 'on piste' in familiar names like Halifax, Nationwide and Aviva.

But there is no such thing as a free lunch. While the issuers are generally of good quality, the bonds are not always actually 'bonds'. In many cases the coupon and repayment is optional, which suggests that perpetual bank debt is a wolf in sheep's clothing. Ironically, one of the biggest holders of this paper is the UK Government, after Alistair Darling's recapitalisation of the banking system. In October 2008, the issue of £9 billion 12% preference shares was announced by Lloyds, HBOS and the Royal Bank of Scotland, in order to strengthen their balance sheets. More recently, Barclays made a public offering of perpetual securities at 14% per annum.

### fallen angels

The second way that investment managers enhance their fund's yield is by holding the debt of 'fallen angels'. These are companies that used to be solid investment grade, but have recently been downgraded to sub-investment grade. Their 'speculative grade' status may follow a sudden revenue decline, or increase in financial leverage.

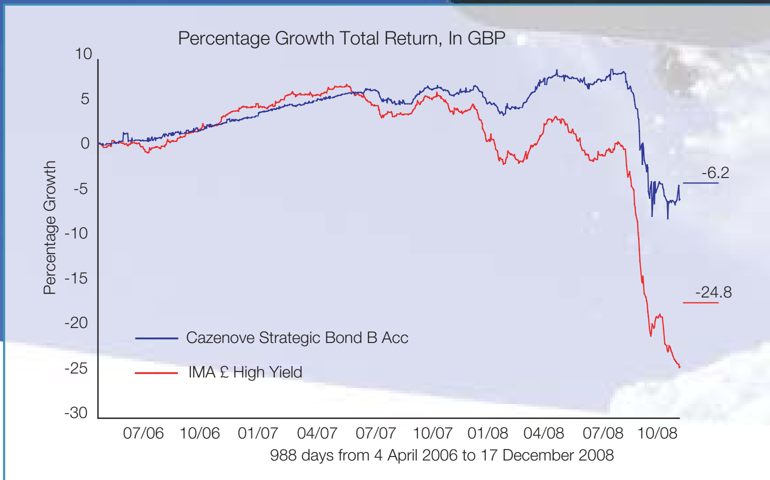
Those companies that made debt-funded acquisitions in 2007 are particularly vulnerable. Without naming names, several such companies exist in the beverages, tobacco, cement, metals and mining industries. Debt-fuelled expansion was all the rage in 2007 and companies in these sectors aggressively pursued acquisition. Boring old European companies that had never borrowed a bean suddenly took the ratio of debt to equity from 10% to 100%. Initially the ratings agencies supported this approach, dutifully assigning investment grade ratings, but when funding dried up in 2008, credit analysts reached for the knife drawer.

We believe that a large number of European corporates will be downgraded from investment grade to 'junk' status over 2009, a process that often causes pension funds and insurance companies to dump paper at any price. This forced selling may present a buying opportunity for specialist debt funds such as the Cazenove Strategic Bond Fund.

### leveraged buy-outs

Another favourite with high yield investors is the debt of leveraged buy-outs (LBOs), such as Boots, Tele-Denmark and Ineos. LBOs are companies that have been acquired by private equity groups, such as Blackstone or KKR, using significant levels of debt. This 1980s invention is the bread and butter of most sub-investment grade funds.

There is nothing intrinsically wrong with LBOs as long as the earnings are stable and debt gearing is manageable. Unfortunately the last crop of private equity deals, in 2006 and 2007, were executed with a high ratio of debt to earnings. In the case of Boots, the ratio exceeded six times, a debt multiple most




bank managers would now laugh at. The good news is that LBO bonds trade with yields of 10-20%, reflecting equity-like risks. By December 2008, the average high yield bond cost less than 70p in the Pound. Clearly some of these bonds will default and some will be restructured, but yields of 10-20% per annum already compensate you for a dramatic loss-rate. In short, this asset class is priced for a 1981 or 1991 style recession.

## emerging markets

A fourth way that managers augment a fund's yield is through emerging market debt. This area has prospered since the early 1990s when bust countries restructured their sovereign liabilities. The asset class now stretches across the globe, encompassing corporates and governments in Latin America, Asia and Eastern Europe.

High yield investors typically look for the right company at the wrong address, with a clear preference for national champions, leading banks and exporters that generate foreign exchange. The safest names tend to be quasi-government issuers like Pemex in Mexico and Gazprom in Russia. The real risk in this sector is political and macro-economic. History suggests that in developing countries it is economic policy that most determines a company's ability to make timely payments of interest.

## so that's how they do it

We believe that every high yield bond fund employs a combination of these four strategies, with varying degrees of success. To join the sector, funds must hold over 50% of assets in sub-investment grade bonds and more than 80% in Sterling.

It should be emphasised that because the underlying portfolios suffer a greater number of defaults, high yield bond funds are considered more risky than other corporate debt funds. By definition, sub-investment grade companies go bankrupt more often than other enterprises. In any one year, it is quite possible that ten out of every hundred sub-investment grade bonds will default. That is why you receive a much higher yield, and that's why these funds are only suitable for long-term investors with a strong stomach.

After the negative returns of 2008, some analysts are calling the bottom for corporate debt. The Sterling High Yield sector fell sharply in the twelve months to December 2008, underperforming mainstream bond funds. For now we are in recession, but when investors start looking for economic recovery, this asset class might do rather well.

### broad definition of Investment Grade:

- Stable companies with higher credit quality
- Manageable borrowing levels
- Rated AAA, AA, A or BBB by one of the principal rating agencies
- eg Siemens, Tesco, Centrica.

### broad definition of Sub-Investment Grade (high yield):

- Lower credit quality
- Exposed to the economic cycle, and or
- Above average borrowing levels
- Rated BB, B, CCC by one of the principal rating agencies
- eg British Airways, Cable & Wireless, British Energy

**The Cazenove Strategic Bond Fund is now available through Skandia's Life and Pensions fund ranges and the Selestia Investment Solutions investment platform.**

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process. Past performance should not be seen as an indication of future performance.

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