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High Yield keeps its credit

60 seconds with the portfolio manager

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This marketing communication is intended for non-professional investors.

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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, Jean-Claude Tamvakis and Nicolas Jullien 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.

How do you take advantage of the high-yield bond market to generate alpha(1)?

Our strategy is based on three main pillars, which allow us to fully exploit the opportunities offered by the high-yield bond market.

- A global and diversified approach

We adopt a global view, covering the two largest markets: The United States and Europe. This approach allows us to invest in a wide range of countries, sectors, ratings, and financial instruments, including Credit Default Swaps (CDS)(2), which offer an additional opportunities for diversification.

High yield bonds, generally those with a rating below BBB- (according to major rating agencies such as Standard & Poor's), are distinct from

(1) Alpha is often considered to represent the added value that a portfolio manager adds or subtracts from a strategy's performance. It represents the performance generated by a strategy that is not due to the general variation recorded by the market.
(2) A CDS is a swap between two counterparties, where one buys and the other sells credit protection referencing an issuer (a company or a country). In exchange for payments, the buyer of the protection will receive compensation in the event of the issuer's default. The CDS can be considered an insurance contract against the default of an issuer. The CDS contract is executed when a credit event occurs, obliging the seller of the protection to compensate the buyer for the unrecovered amount from the issuer.

investment grade bonds. We favour an active and conviction-driven management style, especially when investing in high yield bonds. This management style is based on in-depth analysis, integrating fundamental dimensions (including ESG analysis), legal, and quantitative analysis.

- Rigorous opportunity selection

Through this analysis, we identify the best market opportunities and select the most suitable instruments. This can include bonds, CDS, or other financial products. Our methodology allows us to adjust our choices to reflect market dynamics and optimize the performance of our portfolios.

- Strict and proactive risk management

Finally, we apply a rigorous risk management approach. We pay particular attention to risks such as liquidity, country risks, risks related to rare events, volatility, and of course, credit risk. A strict selling discipline is used to limit losses, and we use asymmetric products, such as hedging options, to protect our portfolios.

Additionally, we favour rigorous criteria, such as minimum thresholds for outstanding issues and the selection of liquid issuers rated by a rating agency or listed on the stock exchange. These requirements ensure optimal liquidity and smooth access to the CDS market.

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.

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 of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Interest rate risk:

A change in interest rates, resulting in particular from inflation, may cause a risk of losses and reduce the performance of the strategy (especially in the event of a rate increase if the strategy has a positive rate sensitivity and in the event of a rate reduction if the strategy has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates and consequently the NAV.

• Counterparty risk:

OTC derivative products and/or efficient portfolio management techniques may be used. These transactions may cause a counterparty risk, i.e. losses incurred in connection with commitments contracted with a defaulting counterparty.

• Credit risk:

Risk that an issuer or a counterparty will default. This risk includes the risk of changes in credit spreads and default risk. Some strategies may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt. These strategies may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the strategy is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the performance. When evaluating the credit risk of a financial instrument, the Management Company will never rely solely on external ratings.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.

Find out more about our funds and their risk profiles:

www.candriam.com