The Investment Podcast

M&G Investments

Episode 28: The Investment Podcast: European High Yield – changing perceptions

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Speaker 1: *The investment Podcast,* brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

David Parsons: Welcome to the latest fixed income podcast. My name is David Parsons and I'm joined once again by one of my colleagues. In this case, it is David Fancourt, Senior Portfolio Manager with responsibility for European High Yield at M&G. Good afternoon and welcome David.

David Fancourt: Hi David. Good to be here.

David Parsons: Jumping right in David, looking at European High Yield markets, do you think they represent good value at the moment? Is this an interesting and potentially attractive entry point?

David Fancourt: Yes, David. Thanks. I think that there's three different measures you can look at the valuation. Firstly yields. Yields are over 7% at the moment, which is almost decade highs for the asset class – 7% compares pretty well with European equities, similar earnings yield to the stocks and versus Investment Grade that are yielding about 4% at the moment. Also, 7% gives you a reasonable amount of protection against adverse movements that could hurt your total returns.

Secondly, spreads. Spreads are above average at the moment. Spreads are the compensation you get for taking extra credit risk in High Yield. If they're above average then [that] tends to lead to better returns in the long run. Finally, prices are low. Prices have fallen around 15 points from the beginning of last year and they're at similar levels to where we were in the depths of the pandemic. This is important because it gives you more symmetry in returns. If an issuer has a hard time there's less far to fall, but if there's some good news or the bonds get taken out, then the bonds have further to rise so there's more symmetry in returns. Overall, I think [there] is a good package at the moment.

David Parsons: What you're saying then is we have an asset class that, certainly on a standalone basis, looks attractive with good yields, low prices of entry and certainly the carry giving you a good deal of protection against any further spread widening that might occur. Obviously, the US market is, perhaps, for many investors the market of choice when it comes to thinking about High Yield. How does the European High Yield market compare to the US market today and what are the different characteristics? Does Europe bring something additional that we don't get from the US market?

David Fancourt: Yes. The European market has always been on the coattails of the US market, but has grown significantly over the last few years. I think there are differences, firstly in quality. The European market is a high-quality market, around almost two-thirds are in BBs in Europe compared to around 50% in the US but at the other end of the scale, there's far fewer CCCs, almost half the amount in Europe than there are in the US.

Secondly, the sector breakdown is different. The US has more exposure to some more cyclical sectors like energy and fracking that can be more speculative. I think another part in terms of relative value is that at the moment you are getting a higher hedge yield in Europe than you are in the US and that's despite being a better quality market.

David Parsons: What I'm hearing is that on a relative basis, the European market gives you better yields than the US market for actually a better quality overall in terms of the composition of the benchmark indices. When one's looking at High Yield, it always comes down to individual securities and the risk, or one could say the fear of default or loss that comes through. How should investors be thinking about default risk in European High Yield risk, but also in comparison to the US market as well?

David Fancourt: Default risk is really important. If you have a default then you have a permanent impairment of capital and that's why you have to take it very seriously. Research is really important when investing in High Yield companies, understanding the risks and also the structure of where you stand if the worst happens. You have to also realise that you have been paid well for taking credit risk in High Yield.

Over the last 20 years, the total return has compounded at 7% per annum despite all the defaults we've seen. Taking that default risk, and you might compare versus the US market because Europe is a high-quality market, we've seen that default rates have been lower over the last 20 years. In fact, Europe has outperformed the US market over the last 5, 10 and 20 years as a result.

David Parsons: I think that's a nice picture of the markets there, but perhaps one other thing we ought to be touching on is how the markets have evolved over a period of years, particularly in the area of investor protections – or lack thereof. The evolution of covenant light, for example bonds and also secured bonds which make up a substantive part of the market as well. The characteristics, perhaps we can draw out some interesting aspects from the European side that are very favourable. How do things look in terms of the risk and the potential for recovery given the changes in the structure of the market over time?

David Fancourt: The financial markets do evolve. I think that the European market has evolved like others and covenant structures will change over time, [it] is up to investors to be on their toes for that. Some protections for investors, for instance, around half of European High Yield is secured. In terms of your overall level of risk, I think that has been pretty similar over time. A lot of thinking about covenant is more to do with relative value between issuers. We find that recoveries tend to be more cyclical and they're higher in good times and worse in bad times rather than a feature of the covenant protection in the bonds.

David Parsons: That perhaps addresses the issue of security and covenants, but when you actually have a default event, I guess there's quite significant differences between the European and US regimes for how defaults are dealt with.

David Fancourt: It's a lot simpler in the US. There's one jurisdiction and a very established Chapter 11 procedure, so companies can file on a Friday and we're open for business on a Monday. In Europe, there's a lot more jurisdictions to deal with and many of them are evolving their own procedures at the moment. The way that creditors are treated may be very different in one jurisdiction than another jurisdiction.

The other difference is there's a bit more stigma still about defaulting in Europe compared to the US. I think that both of those are reasons why we see lower default rates in Europe compared to the US even if we control for the better quality of the European market compared to the US.

David Parsons: It does certainly come through in pricing as well. When you look at the markets, you are more than compensated for the risk of default in European markets at the moment in terms of the level of credit spreads that's available relative to historic levels of default that have been observed. Bringing it back to the asset class as a whole – European High Yield – is this a tactical investment asset class, or perhaps it says something more long-term about buying and owning the asset class that's positive for investors?

David Fancourt: Certainly history has suggested that holding onto High Yield has been the right choice. Over the last 20 years, European High Yield has compounded at 7% per annum, which is about 3% more than Investment Grade. Holding onto high compounding asset classes has done investors well. It's difficult to time the market and the costs are quite high as well. The roundtrip cost of getting out of High Yield can be over 1%. I think that there's a strong case for investors to consider High Yield as part of their portfolio as a strategic component of that portfolio.

David Parsons: I think that's an interesting perspective because for the most part, investors in European High Yield have always treated it as an asset class that is opportunistic. Your point about trying to market time is well made. That's always difficult and challenging: to capture a good deal of the flow of a rally from getting in at the start of a rally. There's a confirmation bias that naturally comes through – that investors will wait until they can actually see that a rally is underway before they will allocate.

Typically most investors will find it difficult to time their exit from the asset class as well. Typically, you'll find that the sell-off will already be underway by the time most investors begin to leave European High Yield. What does that give us? Perhaps investors are maybe capturing, at best, 60% to 70% of a rally in terms of trying to market time and asset allocate, which if you can do that consistently over a very long time, will typically deliver good returns.

It is challenging and certainly, there is a strong case to say that holding a strategic allocation through the cycle with a manager that is then seeking to add modestly to returns on the top through risking and de-risking the portfolio according to the available opportunities through the cycle, I think could be a powerful tool for investors to keep in their armoury rather than seeing it as a tactical tool, perhaps seeing it more as a strategic one.

David, it's been very interesting chatting with you. Thank you for your thoughts on the High Yield market and we'll continue to update investors and colleagues as things evolve in the market over the next three to six months and perhaps revisit this in the summer. Very much appreciate your time. Thank you.

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David Fancourt: Thank you.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice or forecast.

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