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ROYAL LONDON
ASSET MANAGEMENT

The Case for Short Duration Global High Yield

In a world of increased uncertainty, and of elevated interest rates, finding an alternative to wider investment challenges that still satisfies client demands leaves little area for manoeuvrability. Azhar Hussain, Head of Global Credit at Royal London Asset Management, believes that allocating to short duration global high yield bonds may provide an attractive solution.

The macro backdrop may appear not as worrying as it was a couple of years ago but neither does it seem terribly exciting, with plenty of concerning developments. Wars in Europe and the Middle East; persistent worries about the US fiscal situation; concerns from the rest of the world that the US Federal Reserve is keeping rates too high for too long; and soft global economic growth. And this is before looking into stickier-than-hoped inflation.

Investors may then struggle to find a fixed income alternative with healthy returns and more limited volatility than other assets within fixed income. We believe that short duration high yield offers investors – relative to the broad market – disproportionate compensation from a yield perspective despite the lower instances of default. We feel there is an opportunity to earn attractive yields with lower levels of credit and duration risk.

This asset class offers less interest rate risk than investment grade counterparts, government bonds, and even longer maturity high yield bonds – providing a strong rationale for an allocation in an increased interest rate environment. The strategy, whether used as part of a broader fixed income allocation or as a standalone strategy, aims to provide an attractive level of income and we believe that our trusted investment process allows the portfolio to be structured to limit volatility that may become more inherent in all markets.

An ever-expanding universe with ever-improving fundamentals

When looking at the market and considering whether to allocate here, it's important to realise that today's high yield market looks very different to the high yield market we saw even 20 years ago. The market has been on a clear journey over the past couple decades: moving away from 'junk' status and towards higher quality, better leveraged names.

In 2001, the size of the market was just over $350bn, spread across some 1,500 issues. By 2011 the market had grown to $1.2 trillion and today it is roughly $2.2 trillion, with over 3,200 issues. The high yield market is much more established, deeper in liquidity, diversified and higher in quality. This evolution underpins the performance of the market: better corporate technicals have resulted in lower defaults, which lends itself to lower volatility.

This institutionalisation of the high yield market has seen quality improve – with a reduction in lower rated names allowing a considerably higher rating than in decades past. This is clearly seen in the dramatically lower number of CCC rated bonds in the market compared to BBs. In 2003 CCCs were 17% of the market and BBs were 36%; by the end of 2023 CCCs were just 9% and BBs had grown to 57%.

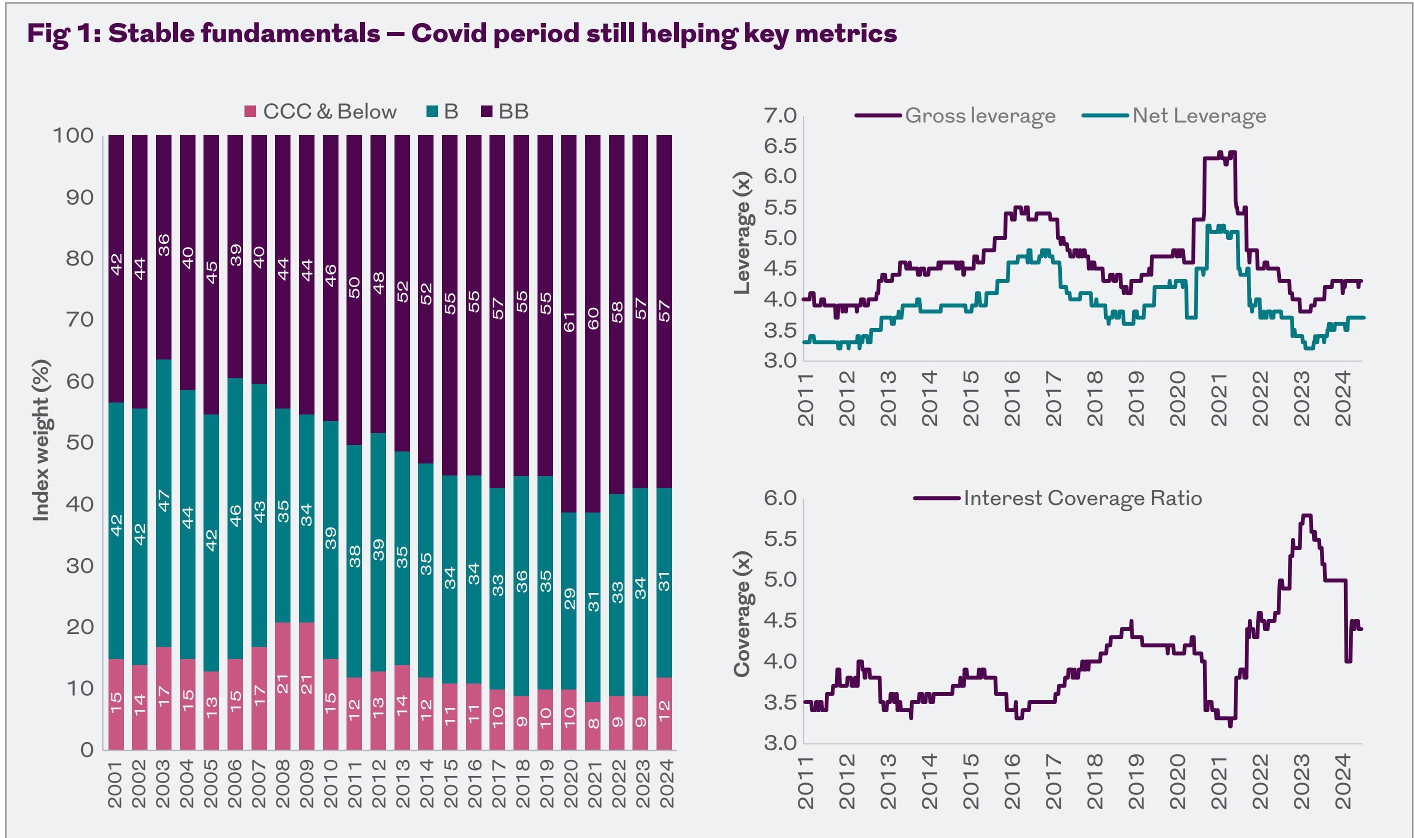


Fig 1: Stable fundamentals – Covid period still helping key metrics

Past performance is not a guide to future performance. The views expressed are the author's own and does not constitute investment advice. Source: BofA Global Research and ICE Data Indices LLC using ICE BofA Global High Yield Index (HW00) as at 31 May 2024.

An ever-increasing important aspect of high yield markets is the role of private debt. We are seeing private debt markets grow in size, hoovering up lower rated companies. This results in public markets being left in a structurally stronger place.

As the CCC portion of the market continues to diminish (Fig 1), taking the most stressed part of the market out of public hands, we can see clear signs of why default rates remain so low. If private markets dry up, will this then have a knock-on effect for us? It might, but we see no signs of private markets closing up: as closed ended vehicles they have already raised a substantial amount of proceeds and still have much dry powder, and we don't see where else they can use it.

As well as improved credit ratings, we have seen issue sizes grow, with bond issues now on average three times higher – leading to greater liquidity.

We haven't seen a correction in yields like that seen in 2022 since the Global Financial Crisis. As a result, valuations look extremely attractive after this correction, especially when you consider credit fundamentals remain robust. Broadly, companies have used stable revenues to prudently build healthy liquidity runways, leading to little additional pressure to refinance in the near term. This has been borne out by relatively low core default rates in the asset class. This is all despite a backdrop of an inflationary environment and higher refinancing costs.

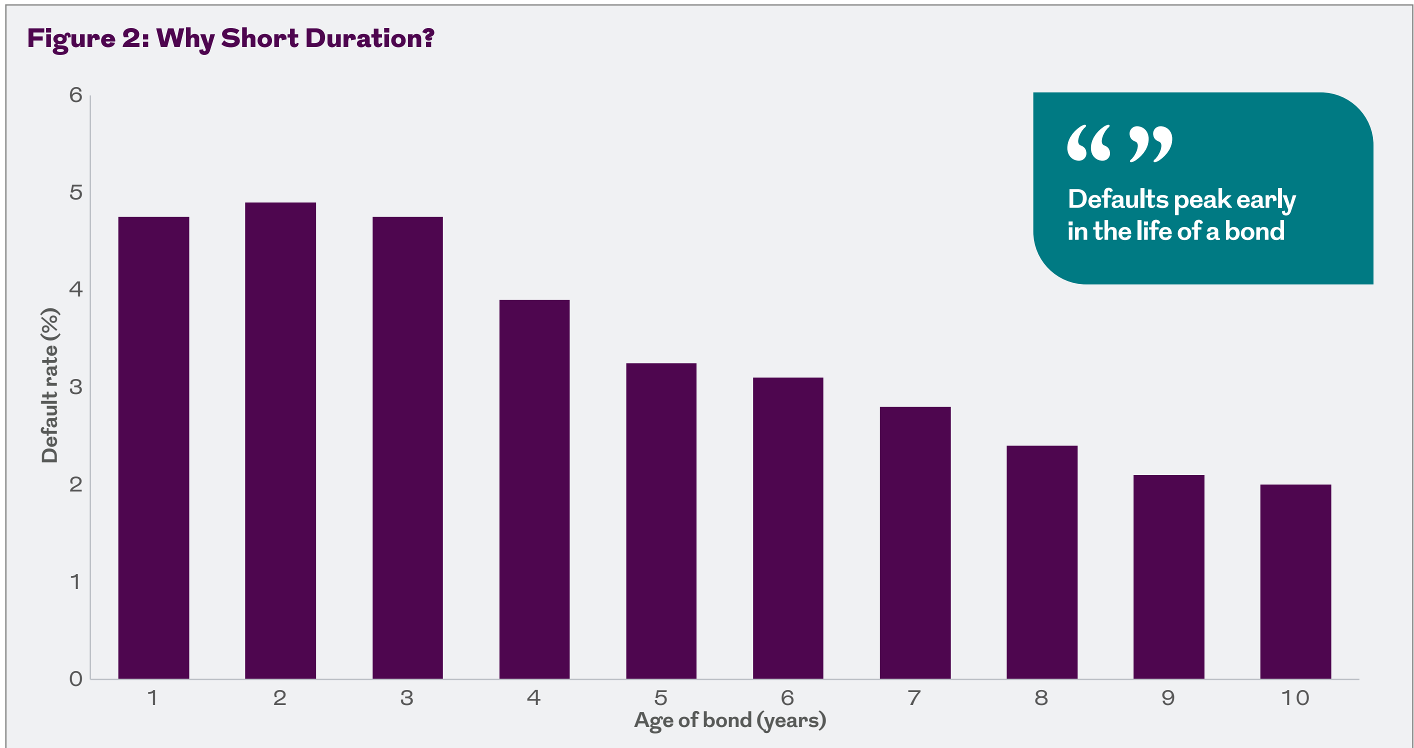
We believe that the combination of attractive valuations, robust fundamentals, and the fact that macro headwinds have abated with the US monetary tightening cycle coming to an end, provides a constructive environment for 2024 and 2025.

Is there value to be found in short-dated bonds?

As the high yield market begins to shift structurally, it exacerbates inefficiencies in the short duration space. The sub-class becomes misrated. Credit rating agencies assign the same rating on a company's bonds, regardless of their tenor. We believe that this overlooks the phenomenon that we've termed 'temporal seniority' – the instance where a subordinated bond is due to mature before a senior bond. Spreads on offer do not differ materially between short and long duration bonds. However, when defaults do occur in global high yield markets, these are more likely to occur at the start of the life of a bond.

High yield bonds are less likely to default the longer that they have been in issuance. Using Moody's data that goes back to 1970, the evidence is clear that instances of default are nearly 50% higher in the first couple of years after a high yield bond has been issued than in the final two years before maturity, with default risk gradually reducing over a 10-year period (Fig 2).

Knowing that defaults peak early in the life of a high yield bond, an approach that focuses on buying seasoned bonds (bonds bought from the secondary market which have been in issue for several years), that only have a few years to maturity, can allow investors to structurally lower default risk within their portfolio.



Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Source: Moody's Annual Default Study: Corporate Default and Recovery Rates, 1970-2015. As at July 2020. For illustrative purposes only.

The relatively flat yield curve is a clear market inefficiency, offering what we see as a sweet spot in terms of attractive yield with limited interest rate duration and reduced default risk, which is particularly pronounced in the case of bonds with one to two years to maturity. By selecting high quality seasoned assets, which are defensively positioned at the front end of the yield curve, we believe that investors can enhance returns in a risk-controlled way.

Where others see risk, we see value

The high yield market is global in nature, with the larger, more liquid US, diverse European and rapidly growing emerging markets all offering different features. We believe that a genuinely global approach offers both greater diversification potential and more opportunities to find attractive bonds. We look at all areas of the high yield market in seeking multiple potential drivers of return.

We target reduced default risk and volatility via our focus on the reporting transparency of the companies we invest into, and with our bias towards larger more liquid issue sizes. We avoid business models which we believe are unforecastable.

We believe that the strategy can achieve a disproportionately large level of spread for the default risk it is exposed to. With detailed credit analysis, we believe that we can mitigate default risk across the strategy.

Our approach relies less on macro forecasting and more on the exploitable characteristics of the short duration global high yield market – in turn, this provides greater certainty of generating the return we seek which is why we believe the portfolio can be structured to avoid volatility that may become more inherent in all markets.

Where to start?

High yield bonds have sometimes been overlooked by investors in favour of investment grade markets, but at Royal London Asset Management we feel there has never been a better time to invest in the strategy. In particular, we see several advantages that an allocation to short duration high yield offers compared to a broad market allocation.

Our aim is to avoid the uncertainty in current markets – we seek consistent and stable returns without taking on too much risk.

Any analysis of many of the funds within the sector shows an array of complex long / short strategies that have struggled to minimise volatility and drawdowns. At Royal London Asset Management, we pride ourselves in being straightforward and pragmatic, and our strategies reflect our beliefs that portfolios can give consistent returns exploiting known inefficiencies that others continually miss.

Our short duration strategy was conceived over 20 years ago and has provided consistent forecastable returns since inception.

It's a simple strategy – we simply buy mispriced bonds close to the end of their economic lives – a strategy that is built on a foundation of never having incurred a default or a serious credit loss in over 20 years.

Our truly global credit product aims to deliver an attractive level of income with limited volatility, in an increasingly uncertain environment. We believe that our Short Duration Global High Yield strategy is well-suited to the needs of a range of investors in terms of diversification, risk/return and liquidity profile.

Risk Warnings

Investment Risk: Past performance is not a guide to future performance. The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Efficient Portfolio Management (EPM) techniques: The strategy may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the strategy to increased price volatility.

Exchange Rate Risk: Investing in assets denominated in a currency other than the base currency of the strategy means the value of the investment can be affected by changes in exchange rates.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain strategy investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the strategy to financial loss.

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