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investing ON THE go

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[INTRODUCTION]
Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. We're delving into the nuances of the high yield bond market today with our guest explaining that although the risker CCC-rated bonds get most of the headlines, they actually make up only a small portion of the market, leaving plenty of opportunities for active managers to take advantage in other areas.

I am Staci West, and today I'm joined by David Ennett, co-manager of the Artemis Global High Yield Bond fund. David, thanks for joining me today.

David Ennett (DE): Thank you for having me on.

[INTERVIEW]

SW: So, let's just set the stage a little bit. High yield bonds pay a higher yield because the companies issuing them are deemed to be more likely to go bust or to not pay the interest, so investors get a higher yield to compensate them for this risk. So, that's kind of the spectrum that we're talking about.

With interest rates high now, pushing up the cost of borrowing for people and companies, people spending less, a recession possibility, does that make your asset class an even riskier place to invest today?

DE: It's a good question to ask, and it's clearly one we get asked quite a lot, but I think, just looking at a little bit more depth of the high yield market itself is probably worthwhile.

So, within high yield, we have those bonds and those companies that are just below investment grade, and these are called BBs. Now, BBs, there will be, you know, companies you've heard of, and I'm sure we'll speak about some, but they are just one rung below investment grade and they do tend to be large, cash flow generative, good companies that I think most people, if they were shown them, would be very comfortable with lending to them.

But at the other end of the spectrum, we have what are called CCCs, and this is based on the rating they have. Now, CCCs are probably, I think what a lot of people immediately think of when they

talk about high yield. These are the riskiest companies and those that there are, to be honest, severe doubts about their ability to repay. But the CCC part of the market is only about 7.5% - 8% of the market, so, although it's probably 98% of the high yield headlines you'll see, it's a very small part of the market. And BBs are around two thirds of the market, and in fact slightly more than that today. And it's quite a nice boring part of the market. And, you know, when you're lending money, being in a boring part of the market can be a good thing.

But just to illustrate how different they are, your one-year default risk - and by default risk I mean the risk that, you know, these companies will go bust and not pay us back - the one-year default probability of a BB is 0.6 of a percent. So, you know, less than around 0.5% in a 12 month period, which is quite low. But a CCC has a 26% chance of going bust in any one year. So, again, just speaking of high yield as high yield kind of misses some of the nuance, which is you know, some of it is very low risk and some of it is extremely high risk.

And really for us, the key for this asset class and you know, deciding how much risk we want to take for our clients is which part of the high yield market to invest in. And we think that what you need to be is quite active and really choose which parts of the market you want to be in. And doing that, you can kind of tailor the amount of risk you take for the outlook.

Now, high yield's not all kind of bad news and taking all this default risk, which you know, you are asked to accept as an investor, but what do you get in return? Well, you do get a much higher yield. And you know, the yield on the whole market is depending on which index you look at, but between 8% - 9%. But also you are being asked to take much less interest rate risks. So, this is the risk that if interest rates go up, bond prices normally come down and that disproportionately hits longer-dated bonds that you see in investment grade, whereas high yield, yes, we have that default risk, but we have very, very little amount of interest rate risk. So, at the moment, again, when talking about risk, it's not just credit risk or earning the risks, there's also risks around interest rates, and I think high yield, if you pick the right spot, is pretty well set up to take a little bit of credit risk or a default risk, and really not take that big interest rate risk because of the inflationary environment.

SW: And will this fund then invest across that whole spectrum that you've just outlined, all the way down to CCC?

DE: We certainly do have the ability to invest across the piece and we do do that. And but at the moment we have a very, very small exposure to CCC-rated securities. But if I go back to times, like right after the Covid crisis, right after the initial lockdowns in March / April 2020, we put a lot of CCC into these funds because the market was extremely cheap. And we made a lot of return out of doing that, but most of the time we prefer to stick to - and our sweet spot is - BB and some B-rated securities. So, we call that performing credit, so these are credits that yes, might have a little bit more risk and often that risk is just because they're not as massive and diversified as investment

grade companies are. And we think the risk / reward is really good in those securities as opposed to CCCs.

One other thing we do in this fund is we very much have a developed market focus, so that's US and European exposure, we don't tend to go into emerging markets. We think that's an opportunity better exploited in, well, notably equities, I would say.

SW: Well, that brings me on nicely to my next question because as the name suggests, this is a global fund so in theory you can go anywhere, but you just said that you preferred domestic or more developed markets. Is there a region that potentially has better value and opportunities than another at the minute?

DE: Yeah, so as you say correctly, we are global, [we have] big exposures in US, Europe, but I have to say one of our favourite regions at the moment and … look, I'm Australian, so it pains me to say this after the summer we've just had in the cricket, is the UK. We see some extraordinary value here and we see a huge amount of negativity that came into the UK market at the end of last year, and we think there's some terrific opportunities there. And we can even look at things like companies that are global companies that issue, say, US dollar paper and sterling paper, where the sterling paper is trading significantly cheaper. Now that, in theory, shouldn't happen. But you know, if you can pick up extra yield simply by having sterling paper and you can hedge out the FX risk if you want - the currency risk if you want - we see some fantastic opportunities.

And actually there's also a lot of UK companies, we think that the market is just kind of being overly cautious and you know, one of the reasons you see that, is the UK represents, or the UK high yield market is only around 3% of global high yield. So, for the vast majority of investors in US dollars or euros, which is the rest of the market essentially, it's quite easy to overlook the UK and the UK doesn't have the massive growth or inflation dynamics that make it jump off the page for a lot of global investors. But if you are prepared to do the credit work and look for the opportunities that are here, it's a very good background for us, we think.

SW: And you have some unique holdings in the portfolio. You have everything from lottery operators to Legoland, to some more commonplace financial services and apparel companies. But one that really surprised me and quite literally jumped off the page at me when I was looking through was Crocs [, Inc.], which I believe is a new addition to the portfolio. So, just walk me through the rationale why Crocs? I've seen them so much more on social media and they seem to really be making a comeback as a fashion choice, if you will, so, what about as an investment choice? Why Crocs, why are they looking so appealing?

DE: Well, first of all, it's very generous for you to call them fashionable because you shouldn't take your fashion advice from high yield bond fund managers! But I mean, I think as closely as we can say, they're objectively ugly objects, but you know, that's part of the appeal of them. Fashion risk is a risk that's very difficult to model and certainly not one that we want to do.

But in all seriousness, Crocs is an extraordinary business. So, you know, the sector of footwear and apparel is - as you noted - quite a bit of it in high yield, and, in general within our funds, we tend not to love this sector because we like companies that have a lot of pricing power and brand equity that they can … that's how you drive economic returns. And if you are at the mercy of retailers and footfall and all these things that we don't really like, that companies can come under pressure, but what we see with Crocs is a company that in the first instance had an amazing [time during] Covid. Look, a lot of people, millions of people were confined to their homes and to sort of console themselves to the realities of the pandemic, they decided that ugly footwear, that they could work from home would be a big part of it. But, you know, this kind of ongoing casualisation of fashion is a secular trend, we think, not just a cyclical fashion one.

And if I look at Crocs, you know, in 2019 they did about just on $1 billion of sales, and in the last year they've done nearly $4 billion of sales. Now for us - and you're right to note that it was a recent addition to the fund - something we need to watch for as well [is] were they a one-off Covid winner? There's lots of businesses - indeed we're speaking today on Zoom [Video Communications Inc], and Zoom is the classic one that had a fantastic Covid, and then it's all sort of withered away - but in Crocs we see a business that has permanently expanded the size of its addressable market. It's moved from its traditional slipper you know, Crocs - let's call them by the proper name - into sandals and their accessories business, all these sorts of things. Now, what's interesting is that they've been able to maintain not only the size of that market, but they're continuing to grow and the rest of the footwear market is kind of stabilised, and some parts of it are down if we look globally, but Crocs kind of have created something.

Now, what the management team did, given the kind of this huge boost they got from Covid, is they said, well, you know, there's a chance this could recede. So, what did they do with these super normal profits is, they bought another brand to try and push through their distribution network. And they did that last year or sorry, the year before last. They borrowed some money to do that, that's why they came to the high yield market. And again, this is why I think this is a good example because it sort of illustrates the opportunity in the high yield market where you have a company like Crocs, which has an equity market cap of nearly $7 billion - so, you know, this isn't private lending, these are big companies, $7 billion market cap - it comes to the high yield market to issue two bonds to do a piece of M&A. It did that and it's bought this business, and sort of pushed it through its distribution network and it's been hugely successful. So, in the last year they've generated free cash flow of about $750 million, and every cent of that has gone to repaying debt. So, lending to a company that wants to do a good sensible transaction and then having that company deleverage or payback debt to us, is a very good dynamic and, you know, Crocs has more than 30% margins, [it's] hugely profitable, and at the moment, [it's] running very low levels of debt relative to its earnings.

And why we like situations like this is, if I look at the index, which is, you know, the entirety of the global high yield market, you have some huge companies in there; you have Ford [Motor Company], you have Petrobras [Petróleo Brasileiro S.A.] and PEMEX [Petróleos Mexicanos],

which are big state-owned oil companies. They can be 3% and 4% of the high yield market. Crocs is three basis points, so, you know, a tiny, not even a rounding error within the global high yield market, but we really like this business because of its individual characteristics; it's very high margin, fantastic growth and the fact that it has this amazing pricing power. And we take, you know, over 1% exposure position sizes or, you know, big exposure in our fund relative to what other funds might do. So, again, when people say, do you like high yield? Well, there's lots of high yield I don't like, but then there are some fantastic opportunities in there and that has to be your approach in this market because, look, as you noted in your opening remarks, inflation's high, consumers are coming under pressure, so, a company that has pricing power and also comes in at a lower price point than a lot of other fashion labels - again, to use the word fashion around Crocs is you know, something I wouldn't stand by - but you know, companies like that are well able to navigate this environment and you know, we've been very happy with that investment since we made it earlier this year. And it certainly has been additive to fund returns since then.

SW: And typically bond funds held in a wider investment portfolio for our listeners are there to add diversification, but the global high yield tends to be riskier and somewhat correlated to equities as well. So, how does a fund like this fit into an investor's portfolio?

DE: Yeah, it's a good question and I think a lot of investors, they don't have a natural place sort of mentally to place high yield. I think, you know, equities are equities and we all get that, we all understand small cap, large cap, EM [emerging markets], it's all kind of intuitive. I think almost everyone, myself included, you know, comes into financial markets from a place of intuitively knowing what equities are. And so, that's kind of straightforward for people.

And then within bond world, we sort of think of bonds as being government bonds or investment grade bonds, which are there as a nice stabiliser, a little bit of income. But what bonds really add to a portfolio is interest rate exposure because they're what we call long duration. And all that means is they have a lot of interest rate risk in them because investors want them to have a lot of interest rate risks, so you buy 10, 20, 30 year government or corporate bonds. High yield literally sits in the middle of that equity sort of traditional fixed income space. And basically the proposition that high yield offers investors is, look, we take some capital, we expose it to some credit risk, we invest it into some companies like Crocs, like Ford, as I mentioned and numerous others. They have a little bit of risk associated with them, so we will get an enhanced level of yield because you're taking that risk.

So, you know, the starting point for bond investors of all flavours is, okay, well I can take no risk or no credit risk and just lend to the government. So, in order for me to lend to a company, you have to pay me a premium for that. And what we're saying is, you know, we're prepared to take a little bit more risk in that company. So, you get paid a lot more lending to Crocs than you do lending to Nestlé [S.A] or Unilever [Plc]or something like that. And, you know, I think that makes sense. But in return, because the high yield market is dealing with riskier companies, put bluntly, you're not going to lend to a very risky company for 20 years because so many things can happen in that time.

So, what the high yield market says is, 'Hello risky companies, we're happy to lend to you, but a) you have to pay us a lot, and b) we're not going to do it for a very long time'. So, the average sort of what we call duration, which is the amount of interest rate sensitivity in the high yield market is around four years, which is very low. So, you're not lending to companies for a long period of time, but you're lending to riskier companies to do that.

So, for investors in this environment where we go, look, inflation's higher, I want to generate some yield, I want some income. Now, I have two choices: I lend to a safer company or a government for a very long period of time, or I lend to a riskier company for a short period of time. What am I most worried about in the world? Am I worried that, hmm, you know what, inflation might be a little bit stickier than people thought? And therefore there's a lot of danger lending for a very long period of time, because as I said, if interest rates go up, the longer you've lent to somebody, the more the price of that bond will go down as rates go up. Or do you say, actually, if I'm worried about inflation being a little bit stickier, that's actually a good environment for corporates ok, particularly high yield corporates, which tend to be what we call quite capital intensive. You know, they're not big growth stocks, they're kind of boring companies that just produce a lot of cash flow. It's actually a good environment for them. So, we think that trade off is a very good one to have at the moment.

But I think, you know, thinking of high yield as a place that is just worried about generating income, generating return now, with a quasi-equity risk profile is probably a good way of looking at it. And look, if you get really negative and think that we're going to go back to 2% inflation and we're going to have a recession and high unemployment, yes, then you are better off owning those really long-dated exposures like investment grade corporates or government bonds. But, if you think we kind of bundle along [with] inflation rates a little bit higher than we'd like, but you know, the economy doesn't completely fall off the rails, actually getting that 7-8%, 7-8-9%, I should say, yield coming to you constantly that you can compound, we think is fantastic risk return. So, that's really where high yield sits, I think.

SW: And if we can just finish with a little crystal ball gazing, the first half of the year has been dominated by inflation, general uncertainty, which we've discussed. Do you think that the second half of the year is going to be more of the same? And then maybe just slightly longer view, how do you see high yield market over the coming years, maybe let's say 3, 5 years kind of longer-term?

DE: Yeah, I mean, I think you are right. Really, if we go back to kind of March of last year when we started getting some of those really shocking inflation prints and we saw all bond markets and risk markets react pretty negatively to that. And with big drawdowns in government bond markets, corporate bond markets and high yield markets, what we've seen over the past year is a growing acceptance that we're in a higher inflationary regime. And behind that we've had central banks very aggressively hiking interest rates; we had the Bank of England last week do another 25 basis points of hikes to the UK base rate, and we might get another one, possibly two hikes. So, you know, central banks are acting very aggressively and you know, historically aggressively to try and bring inflation down.

So, I think the market has moved on from sort of inflation denial a little bit. And where we are now is, it's kind of the data which remains very, very strong globally and it's really confusing a lot of people; like, yes, global earnings have come off a little bit, but you know, the consumers are still in good shape, the labour market's still very tight and growth's still looking pretty good. And in the last couple of weeks we've had … most recession calls get sort of wound back a little bit. And so, what I think the sort of second half of the year looks like is, you know, that sort of growing realisation that the downside mightn't be as pronounced as feared. But against that, you still have a lot of fear of what's called the lag.

So, it's financial market parlance that central banks - so that's the Fed or the Bank of England - that their actions to hike rates etc., those impacts happen with a lag. So, you hike rates a lot now and the real impact isn't felt from perhaps 12 -18 months, was the traditional kind of thinking behind that. Well, we've been hiking for kind of at least that now and there's a little bit of a slowdown, but not, certainly not nearly as much as I think markets would have been led to believe. And I think if we got into our time machine and went back 18 months and said, look, the bank of England's going to hike rates, I think it's 14, 15 times in a row, and we'd be where we are in terms of unemployment and growth, no one would believe you.

So, I think people are still cautious of those lags, but there is a dawning almost acceptance that the downside, you know, ie. the anticipated recession that everyone's been talking about, mightn't be as bad as feared. Now for us, that's an excellent, I mean, we really couldn't want a better environment for that. But you know, frankly, if growth is too strong, that's bad for high yield, and if growth is very bad, that's bad for high yield, but kind of, oh wow, we might trundle along at 1-2-3% growth is kind of as good as it gets for us because, you know, inflation is lower than it was, but it's still decently high. But you know, on the other hand, you're not moving into a sort of a crushing recession. So, that's a very good backdrop for us.

And going further afield, sort of 4-5 years, I think looking at high yield and what it's done over the past 10 years in terms of returns, which have been very good, but also the market quite unusually - even compared to investment grade - has actually de-risked. So, if we go back to what I spoke about before, the CCCs, which you know, that very risky part, you know, 1 in 4 chance it goes bust in any year, they used to be 17% of the high yield market; they're now sort of 7-8% and going lower. There's just a structural decline in that stuff. So, if we go forward 3, 4, 5 years and this market is as I believe it will be overwhelmingly BB and B market, I think that's about the best risk / reward trade-off we could imagine.

And something history tells us about high yield is, it’s one of the best predictors of future returns. And of course, I cannot and will not, you know, I can't predict the future. But one of the best historic predictors of what you get returning in high yield, is your starting yield. Now, you know, it can go up and down in the interim, but historically it's actually a pretty robust condition that, over a 3-5 year period, you know, if you buy this asset class at 9% yield or 4% yield or 10% yield, it's a

pretty good proxy for what that returns - on an annual basis - over that period of time. And I see that potential certainly in high yield at the moment.

And while we are trimming that CCC piece because risk / reward isn't great, in that sort of core BB / B just performing good companies that generate cash, we see huge potential for returns in there and think it is, as ever with high yield, under-appreciated by a lot of investors.

SW: Well, on that optimistic note, let's end it there. David, thank you so much for making time to talk to us and really give an excellent scope of what's happening in high yield at the minute.

DE: No problem Staci, thank you very much.

SW: As discussed in this interview, the managers of this fund use a different strategy than many others. Instead of just concentrating on the biggest and most well-known companies, they look at smaller ones which might be overlooked – a strategy which has been successful for them over the life of this fund. To learn more about Artemis Global High Yield Bond fund, please visit fundcalibre.com