Why Global High Yield Makes Sense for Australian Investors

Abundant opportunities for selective and experienced managers.

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KEY INSIGHTS

- Global high yield has carried half the risk relative to equities and a stronger risk/return trade-off potential
- Investors need to look beyond a handful of markets and adopt a global approach spanning developed and emerging markets
- Credit selection is crucial, and support from an experienced, well-resourced active manager will likely be a differentiator

These are challenging times for Australian investors seeking cash-generating assets. Traditional sources are down to a trickle in the post pandemic era as major central banks keep interest rates low, ending an era when you could load up on safe-haven bonds that produced stable income flows.

The window of opportunity offered by high dividend stocks, which have the added benefit of franking, can be uncertain too as corporate payouts fluctuate with market cycles making these income streams hard to predict.

Indeed, recent outbreaks of the Delta variant of the coronavirus across Australia, and the resulting lockdowns, have introduced a high degree of uncertainty to the economic outlook and the central bank expects to keep rates unchanged in the near term.

The time has come for investors to widen their hunt and increase their familiarity with a broader range of fixed income securities available.

High Yield Issuers Are More Familiar Than You Think

High yield bonds are a prime example of an asset class with a strong track record of delivering good income, especially during times of austerity. Awareness about this near USD5 trillion market is low among Australian investors, long used to defensive fixed income securities helping produce steady income streams.

Defined as investments that are rated BB+ and below, high yield bonds are likely to benefit more from the sustained economic recovery than those with higher ratings, particularly those that have survived 2020 and have stable balance sheets.

Companies in the high yield universe include well-known names like Rolls-Royce, Twitter, Under Armour and Samsonite. We think that if an investor is happy holding the equity of these companies then they should be even happier to hold their debt as an investor sitting higher on the capital structure.

There are other household names in the high yield universe such as Kraft Heinz, and Ford Motor, which have issued debt. Some prominent technology companies also have sub-investment grade debt ratings and use the bond market to raise funds. Examples include Netflix and Tesla, better known for their highflying and sometimes volatile equities.

More Volatile Than Equities? Think Again

High yield debt is often overlooked by some investors as it is misconceived as being too volatile. Data as at December 31, 2020, shows that over the past 10 years, both the annualized standard deviation and the maximum drawdown of the ICE BofA Global High Yield Index has been around half that of the MSCI All Country World Index.[1]

Crucially, this reduced risk does not come at the expense of a major loss of return. Over the past 10 years to December 31, 2020, global high yield represented by ICE Bank of America Global High Yield Index delivered an annualized return of around 7% compared with around 9% for global equities represented by MSCI All Country World Index.[2] So overall, global high yield has carried around half the risk of global equities over the past decade while it may potentially offer a stronger risk/return trade-off.

This is also borne out by the risk-reward comparisons — as at December 31, 2020, the 10-year average of Global High Yield represented by ICE Bank of America Global High Yield Index Sharpe ratio at 0.9 is 0.2 higher than Global Equities represented by MSCI All Country World Index, and 0.5 lower than Global Treasuries represented by the Bloomberg Global Aggregate Treasuries Index.[3]

Meantime, the credit quality of the high yield universe has improved because of a combination of factors. There has been a sharp rise in the number of fallen angels — companies whose debt was formerly investment grade, but which have been downgraded to high yield. A record amount of fallen angel debt in 2020 — almost USD 250 billion worth — has raised the average rating of the ICE BofA Global High Yield Index. The proportion of constituents in the benchmark rated BB has risen to 60% from 40% a decade ago.

Equity returns are expected to be lower in 2021 as last year's stocks rally will likely be difficult to match. This makes high yield bonds, which historically have tended to outperform equities in the years immediately following a recession, an attractive option, in our view.

So Where Are The Opportunities?

Well, firstly, to find the right opportunities to create sustainable and meaningful income, we believe investments should be selective rather than adopting a top-down strategy.

This means it is critical to look beyond a handful of markets and adopt a truly global approach spanning developed and emerging markets.

Secondly, to do this properly requires an active investment manager with significant scale and expertise because the high yield universe is large and complex, and management of credit risk is critical to seek preservation of capital. Not to mention the high transaction costs associated with the index strategies.

In our view, some of the best opportunities in the high yield universe exist in defensive areas. The cable industry, for example, appears to have solid prospects as the shift toward working from home may continue beyond the coronavirus pandemic, boosting demand for data transfer.

Another area worth considering is food retail, and in particular supermarket chains. These entities offer potential stability similar to the cable industry and can offer some compelling opportunities when there are changes of ownership, as recently shown in the UK supermarket group ASDA buyout. Such deals result in capital structure

[1] Source: ICE, MSCI. See Additional Disclosures.
[2] Source: ICE, MSCI. See Additional Disclosures.
[3] Source: ICE, Bloomberg, MSCI. See Additional Disclosures.

changes and potentially increased leverage, which means greater risk — and may offer good opportunities.

Risk aversion is also reflected in the declining default rates — global high yield default rates have fallen to 0.64% in the first quarter of 2021, down from 1.16% in the fourth quarter of 2020, marking the lowest point since Q3 2019, according to S&P Global. Riskier opportunities can be found in industries undergoing significant change. The automotive sector, for example, is in the process of a major secular shift toward electrification.

In a low growth environment, we believe that the global high yield asset class can provide valuable diversification opportunities to Australian equity investors. Consider this — over the decade to June 2019, the S&P/ASX 200 Total Return Index generated a return of 10.0% a year, versus 5.3% a year for the S&P/ASX 200 price index. Removing the price effect left a dividend return of 4.7%. In contrast, as at 30 June 2021, T. Rowe Price Global High Income Fund – I Class had a total return of 21.2% split into 13% capital growth and 8.2% income, on a cumulative basis since its inception on 4 May 2020, net of fees.[4]

Finally, it is worth noting that because of its track record of delivering consistent returns, high yield debt works most effectively when included in a permanent asset allocation model to benefit from compounding interest over time.

[4] **Past performance is not a reliable indicator of future performance.**
Source for performance: T. Rowe Price. Figures are calculated in AUD. Net-of-fees performance is based on end-of-month redemption prices after the deduction of fees and expenses and the reinvestment of all distributions. Gross-of-fees performance is the net return with fees and expenses added back. Figures include changes in principal value. Investment return and principal value will vary, and an account may be worth more or less at termination than at inception.

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