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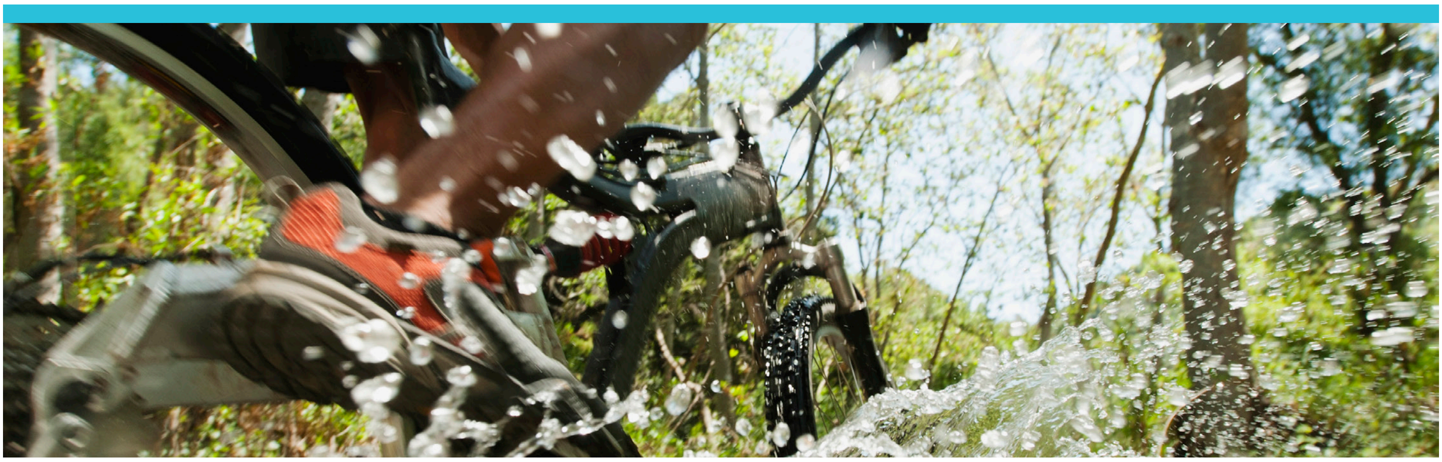
Global High Yield—Managing Through Volatile Markets

Fundamental research is imperative as growth weakens.



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Portfolio Manager

Key insights

- Prices often become dislocated from fundamentals in volatile markets, which creates potential attractive entry points for investors.
- However, the macro backdrop is challenging, so fundamental research and a risk-aware approach are imperative as defaults could start to pick up over the next few quarters, albeit from a fairly low base.
- We favor European high yield over the U.S. and see attractive value opportunities in European cable and services companies.

This year is potentially one of transition in the global high yield space with the focus expected to move from macro concerns dominating the market narrative to worries over credit risk. The knock-on impact of this is likely to be higher credit volatility. To navigate this more challenging environment, it's more important than ever to follow a disciplined and risk-aware investment process that emphasizes rigorous research. Why? Because it's not just about picking potential winning companies; avoiding losers is just as important, particularly in the current climate where defaults could start to pick up over the next few quarters due to the slowdown in growth.

Volatile Markets Demand Far-Reaching Insights

Credit-intensive research is essential to fully understand a company and the potential risks and rewards involved with investing. This is at the heart of our approach, with a global team of more than 25 high yield contributing analysts specialized by industry, region, and sector. This gives each analyst the in-depth credit and structure analysis skills that are needed to accurately assess the optimal risk/return trade-off. In addition, our analysts also leverage and collaborate with investment-grade; sovereign; equity; and environmental, social, and governance (ESG) analyst teams, which allows for a holistic credit assessment of a company. This cross-team effort combined with skilled active management helps inform decision-making and prudent risk management, which we believe leads to better long-term results.

As part of our process, analysts routinely stress test companies in order to develop a deep understanding of how companies might perform in a range of different market environments. Default scenarios are also constructed to identify the catalysts that could potentially trigger a credit event, as well as the likely effects thereafter. We conduct scenario analysis on an ongoing basis in order to identify both risks and opportunities to each individual security.

This past year, our analysts have been undertaking deep assessments of how companies in their coverage area might be impacted by slower growth and an environment of higher interest rates and inflation. For example, will the company be able to pass potential increased input costs onto their customers?

Could their margins be impacted? And, if so, what does that mean for future revenues and cash flow generation? Often, some of the impacts come with a lag, so it's not just about evaluating what the conditions mean for a company now, but also how they might fare in 2024 and beyond.

In a climate of potentially higher credit volatility, it's important to stick to our stringent investment process that prioritizes fundamental research. This should not only enable us to potentially uncover great opportunities where prices have become dislocated from fundamentals, but also help us to avoid companies that might not survive the more challenging macro conditions.

Diversification Potential

Looking beyond the traditional U.S.-centric market and more broadly at the global high yield space is also important in the current environment as it creates potential opportunities for diversification. The high yield bond market is about five times larger than it was in 2000, and the investable universe has become much more global over the last two decades. At the end of 2000, North American issuers made up almost 90% of the market. As of March 31, 2023, this had dropped to less than 60%, with European issuers accounting for 24% of the broad market and emerging market issuers at 17%[1]. This expansion has led to a more diverse opportunity set in the asset class in terms of both industries and economic cycles that active managers can strive to exploit.

Favor Europe Over the U.S.

At present, we believe that Europe offers value despite its challenging growth outlook—although selectivity is more important than ever. The European high yield market should benefit from having less exposure than the U.S. to cyclical markets, such as commodities. Europe also has higher credit quality than the U.S., with more companies rated BB (67% in Europe versus 50% in the U.S.) and fewer companies rated CCC and below (5% in Europe versus 11% in the U.S.)[2]. Furthermore, Europe's market is younger and less mature than the U.S., meaning it potentially offers more opportunities for price and information discovery, which we can potentially take advantage of with our research and active management.

Sector Picks: European Cable Operators

Digging down further into sectors, we see value in European cable operators. This industry is supported by long-term trends in media consumption and stable, recurring revenue business models, which is important at a time when growth is slowing. We are also finding some value in the services sector. This is a large and highly diverse sector with lots of potential interesting opportunities on offer, but with sticky prices and slowing growth, fundamental research is imperative.

Analyst Spotlight

Introducing ***Jonathan Moore***

- 23 years of investment experience
- 6 years with T. Rowe Price

Company Example: Verisure, a defensive security business operating in the European residential household and small business monitored alarm market.

Thesis: We see potential for organic growth in the European market, given still-low penetration rates compared with the U.S. Furthermore, the service is often considered nondiscretionary by customers, which leads to low churn/attrition rates and long average lifetimes. Leverage is high, however, which is typical for asset-life service businesses. But cash generation before new customer acquisition costs is reliable, in our view, even in an economic downturn.

The specific security identified and described is provided for informational purposes only, does not represent a recommendation, and does not represent all of the securities purchased or sold for advisory clients. No assumptions should be made that investments in the security identified and discussed was or will be profitable.

The foundation of our investment philosophy is the detailed understanding of the companies being considered. We seek to invest in companies that have strong and improving credit profiles within their industries. Equally important are the companies to be avoided. Our focus seeks to identify and avoid weak companies that are either run by poor management teams or contain situations that create an elevated expectation of default. A climate of macro headwinds and higher credit volatility offers potentially high rewards but also risks. Security selection is imperative, and key to that is fundamental research and a risk-aware approach.

[1] Data as of March 31, 2023. Source for ICE BofA data: ICE Data Indices, LLC, ICE BofA Global High Yield Index ("ICE DATA") is used with permission. Please see Additional Disclosures page for more information.

[2] Data as of March 31, 2023. Sources: European high yield represented by the ICE BofA European Currency High Yield Const. ex Sub, and Fin Index. U.S. high yield represented by the J.P. Morgan Domestic High Yield Index. (See Additional Disclosures.)

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Fixed Income

Capital risk - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk - an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk - to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk - a portfolio 's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk - investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk - the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk - operational failures could lead to disruptions of portfolio operations or financial losses.

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