HEALTH WEALTH CAREER

HIGH YIELD BONDS UNDER STRESS?

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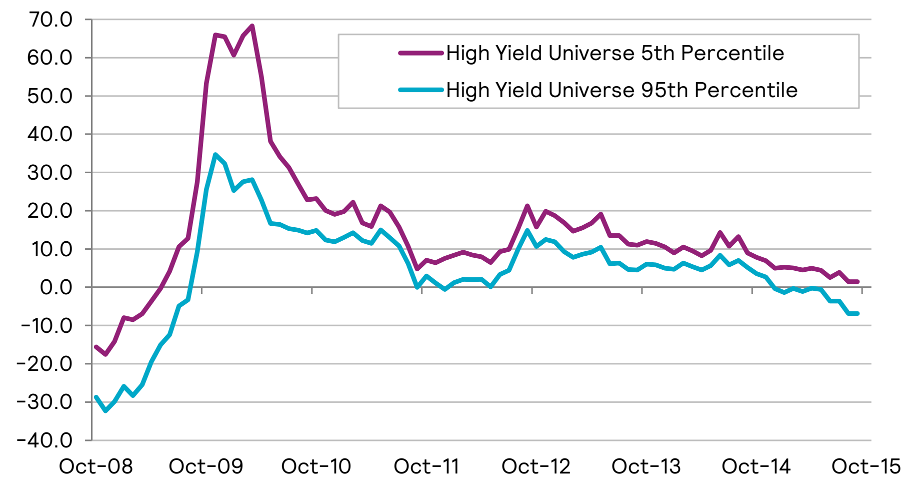
WHAT PROMPTED THE MARKET DISRUPTION?

News broke last week that the Third Avenue Focused Credit mutual fund suspended redemptions and announced a gradual liquidation of the fund. This contributed to a broader sell-off in high yield bonds as concerns over market liquidity rippled through the market. It is important to note, however, that the Third Avenue fund was not representative of the typical high yield bond fund. Its holdings were more typical of a distressed fund as 45% of its holdings were rated CCC or lower and 50% were unrated. A more typical exposure for high yield funds is approximately 10% of exposure to CCC and unrated bonds. Additionally, the positions were concentrated with the largest position at 4.5% of the fund. The fund was down 27.0% YTD when it suspended redemptions, compared to 3.6% for the high yield universe as a whole. Though the high yield market is weak presently, markets remain functioning, and we expect more traditional high yield mutual funds to be able to satisfy redemptions.

THE BROADER PERSPECTIVE

The collapse in energy prices has been particularly rough on the US high yield universe because energy comprised nearly 15% of the index before the sell-off. It has spilled-over to the rest of the universe, as spreads on non-energy issues have also widened. This has resulted in negative returns for the majority of US funds in 2015.

Table 1: U.S. High Yield Bonds Universe – 1Y return Rolling Returns Ending October 2015

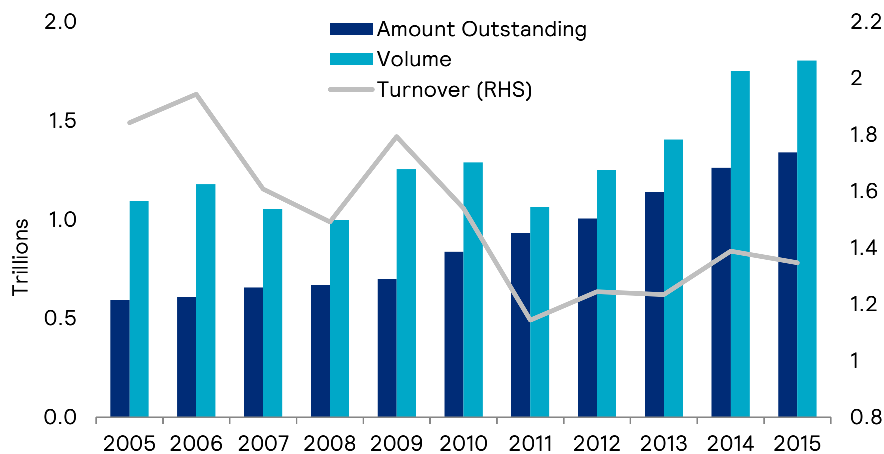


Source: Mercer Insights

Issues rated CCC, which made up a substantial portion of the Third Avenue fund, are down more than 20 percent from their peak in June 2014. The selloff in high yield accelerated in mid-December, losing 5% since December 11, 2015 as investors attempted to ascertain where, and to what extent does high yield exposure exist.

The liquidity issue, while more significant with the Third Avenue fund is not new to high yield market participants. There are many ways to define and/or measure liquidity in credit markets, and liquidity levels appear worse than the pre-crisis period (mostly due to financial reforms following the GFC) by virtually every quantifiable measure. This includes wider bid-offer spreads, decreasing turnover ratios (high yield trading volume as percentage of total market outstanding), and lower bank/dealer corporate bond inventories.

TABLE 2: HIGH YIELD VOLUME AND TURNOVER SINCE 2005



Source: Barclays Research

While these well-documented changes in market liquidity can exacerbate the challenges of managing a high yield mutual fund (especially during periods of sustained outflows), most high yield fund managers have already changed the way they manage portfolios to address the issue. Most managers have reduced CCC-rated exposure over the past year. Moreover, managers have increased cash balances and made greater use of derivatives (e.g., CDS and CDX) and ETFS.

The particular Third Avenue fund was known for having a higher risk (or distressed) profile and is not indicative of the high yield mutual fund universe (or Mercer's A-rated list of strategies). The fund's holdings barely resemble most actively managed high yield funds; according to Morgan Stanley, of the top 10 high yield mutual funds, the median holds only 7.4% in CCC-rated bonds and 7.2% in non-rated issuers.

ASSESSING YOUR EXPOSURE

When discussing high yield and liquidity, it is important not to conflate market liquidity with price volatility. In fact, in recent years, the liquidity premium in high yield is often negative (less liquid securities trade at a premium). This is due to the fact that in a volatile market, the most liquid bonds (often those held by large ETFs) are most easily sold and also most frequently marked to market. Meanwhile, the prices of more risky and less frequently traded bonds stay artificially stable. This phenomenon of "artificial stability" is likely to have been a factor in the sudden redemption problems surrounding the Third Avenue fund.

It's unlikely that a typical diversified high yield fund will have trouble meeting redemptions and we believe most high yield investors view this incident as an outlier. However, this news is leading to some technical pressure as mutual fund managers need to prepare for redemptions, potentially selling holdings at unfavorable prices.

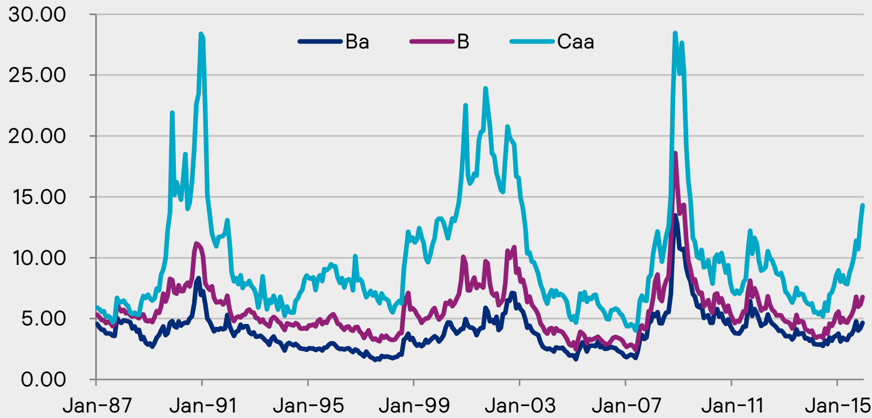
We have been discussing potential fixed income liquidity issues for some time, namely the disappearance of banks as the providers of liquidity due to the invocation of the Volcker rule as part of the Dodd-Frank reforms, as well as the proliferation of daily liquid vehicles for high yield and bank loans since the financial crisis. We suggest the following considerations:

1. Understand the plan's direct and indirect exposure to potentially illiquid sections of the credit market, including high yield bonds, bank loans and structured credit to ensure it is in-line with the plan's stated liquidity needs.

2. Consider the liquidity profile of underlying holdings in mutual funds and other commingled funds and the liquidity offered to investors to ensure they are reasonably aligned.

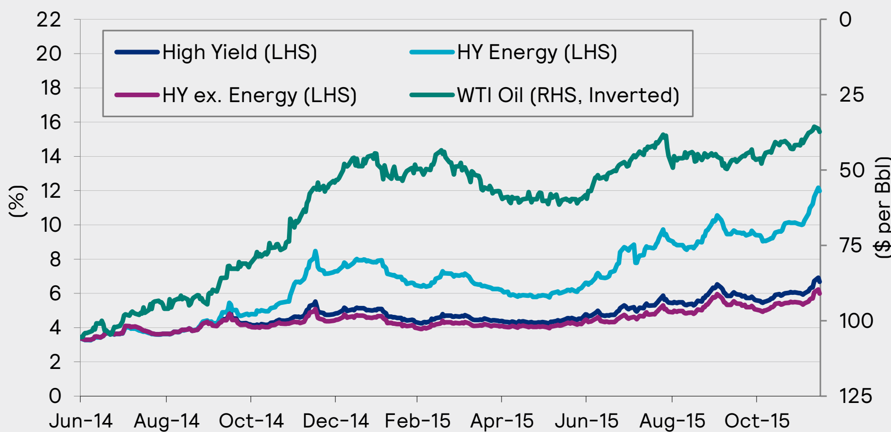
In the short term, it is anticipated that retail outflows from high yield funds will accelerate. This could potentially trigger a cycle of liquidity issues for some funds as they absorb losses from falling commodity prices and rising interest rates, which could ultimately lead to continued investor redemptions. Investors' growing concerns are of course reflected in credit spreads. The option-adjusted spread on the Barclay's High Yield index surged to 6.9% on December 14 from 6.0% at the start of the month and 4.8% at the beginning of 2015.

Table 3: High Yield Bond Credit Spreads



Source: Bloomberg

Table 4 High Yield Bond OAS versus Oil Prices



Source: Barclays and Bloomberg

CONCLUSION

Considering all factors, exposure to energy related high yield issues are of immediate concern, and we continue to recommend using active managers for high yield and other riskier credit mandates. The potential for credit contagion effects in equity markets should also be considered. However, when investing in both high yield and equities, clients should consider expected volatility and potential periods of illiquidity and be prepared to weather such volatility. A well-diversified portfolio should serve as the best defense. Finally, the turbulence in the high yield credit markets could create opportunities for long-term, patient investors.

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