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High Yield Bonds: limiting risks with the Value Strategy

High yield bonds were the stars of the investment universe in 2009. This year, investors will still be able to earn hefty returns with these high-performance instruments. But careful selection has become even more important.

Corporate bonds rose to financial market stardom last year. On the "A-list" were high yield bonds, issued by companies with low credit ratings - making them relatively poor credit risks. In 2009, the Merrill Lynch Global High Yield (euro hedged) index grew by 60.7 percent. The global equity index MSCI World (TR, euro hedged) increased by only around half as much in the same period (30.8 percent). And despite all of the bad news from Greece, Portugal & co., investors stand to earn healthy returns with high yield bonds this year as well. The Merrill Lynch index has already seen a 2.9 percent increase since the start of the year, compared to the MSCI World, which has fallen by -0.6 percent (data as at 03 March 2010). What gives high yield bonds their star power?

No return without risk

There is one incontrovertible rule of the financial world: higher risk equals higher return. And high yield bonds entail such higher risk. These issuers have lower credit ratings from agencies like Standard & Poor's, Fitch or Moody's - in the range of "BB+" to "CCC-" (S&P scale). This means, depending on the liquidity situation of the company, the rating agencies consider their ability to make interest and principal payments to be critical or even threatened. To gain access to lenders, these companies must pay a higher premium over the risk-free interest rate than, for instance, a government bond. After all, investors want to be compensated for the higher risk they are taking on.

Additionally, a climate of doom and gloom has spread throughout the financial world. Neither banks nor bond investors have been willing to lend capital to companies - much less companies with poor credit ratings. Nobody wanted to bear the risk of default, and prices for corporate bonds collapsed accordingly, making the same instruments available at the same interest rates at a distinctly lower price.

Those who took advantage of this opportunity saw sizeable yields last year. Since mid-2009, there has been a considerable rise in investor confidence, a trend that will also continue in 2010. Companies are focusing on cost cutting and debt reduction in order to increase future profitability - typical management behaviour in times of crisis. As a result, lenders can

generally reap the rewards after phases of contraction: the mood brightens and investor confidence increases in the economy and companies. This leads to higher bond prices and provides attractive returns for those brave investors who bought in when prices were low.

In this context, however, it is essential to choose the “right” high yield bonds. Investors should not underestimate the risk of default. Indeed, according to the Moody’s rating agency, 10 percent of all high yield bonds listed worldwide defaulted in 2009 - the highest default rate since the Great Depression of the 1930s. Thus, a selection strategy that is well-known for equities is also the key to success in the bond market: the Value Strategy.

The Value Strategy for bonds

Academic studies of equity returns since 1926 by Eugene Fama and Kenneth French show that value stocks generate higher returns over the long term than growth stocks, though value and growth stocks are back and forth as the top performers over the short to medium term. Value investing in the bond sector means that selection focuses on the intrinsic value of the bond issuer. The high yield portfolio contains bonds of undervalued companies with low net debt and overestimated default risk. The fund management analyses the companies for earnings, assets and price. The sector or region of the companies is of lesser importance. For reasons of risk mitigation, however, prudent diversification should be maintained with respect to countries and sectors - but also different rating classes.

Small companies are often the first choice for value investors in the high yield market. As a result of their lower levels of capitalisation, rating agencies tend to automatically rate them lower than the big players. In studies by Edwin J. Elton and Martin J. Gruber, the Fama-French Factor was applied to the bond market. They found that 85 percent of the interest difference between corporate and government bonds is attributable to a counterbalancing of systematic risks. For instance, company size is considered by lenders when assessing credit risk. Smaller companies automatically pay higher rates of interest for a loan than a comparable larger company with an equivalent degree of debt. Similarly, small companies must pay investors more interest on their bonds, despite the fact that their healthy balance sheets minimise the default risk of these companies.

The markets have improved since last year, but outlooks are still good for high yield bonds. Investors, however, should not just put their money into any bonds they can get their hands on. They must precisely analyse the companies to which they intend to lend their capital. Those who are unable to perform such a thorough analysis should invest via a fund instead. And one thing has to be made clear: high yields should be considered an add-on investment comprising no more than about 10 percent of the portfolio.

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