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The short appeal of high yield

In a rising rate environment, the short end of high yield remains appealing, according to Insight Investment's Ulrich Gerhard and Cathy Braganza. Here they explain why they believe cashflow and callability are key at the short-dated end of the market.

Investing in short-dated high yield bonds is a "powerful instrument" in an environment of central banks raising interest rates, according to Insight Investment's London-based high yield portfolio managers Ulrich Gerhard and Cathy Braganza, who run a dedicated short-dated high yield strategy.

Gerhard says higher interest rates should not be detrimental to high yield bonds as long as the issuing company's fundamentals are not jeopardized. In this environment, he argues, it is important for the underlying company to be generating cashflow to pay both its coupon and its debt.

"The important thing is they are not zombie companies, they have cashflow and can pay the higher prevailing rate and execute their business plan," Gerhard says. But it pays to be discerning, he adds, noting "there is high yield and there is junk."

He says returns in this asset class tend to be made through carry, so whenever a bond is called an investor can sit on cash and then decide when to reinvest at a higher prevailing rate. Braganza says cash generation is a sign a company can pay its coupon. She notes sectors including consumer services, industrials and financial services typically have cashflow visibility, but it is less clear in areas such as tech and online retail.

Call premium

According to Braganza, the ability to call a bond is the "most important thing" in high yield. This is because of the call premium generated when a company calls a bond early.

High yield companies usually refinance bonds before maturity, notes Gerhard, because if the market is closed and a bond is maturing, a company won't have a bank facility to draw on, so a forward-looking company would refinance the capital structure in advance.

Braganza says investment grade companies tend to have permanent capital structures, whereas high yield companies are more fluid, often changing and transforming their businesses, if, for example, working toward an event to enhance equity returns, such as an asset sale, mergers and acquisitions (M&A) or growing earnings before interest, taxes, depreciation and amortization (EBITDA). This means their capital structure is being matched to the changing business which can generate cashflow to pay off bonds before the term ends.

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"If I am a high yield company, I can give you your call premium and your par back and I refinance in the market because I am a bigger and stronger company," says Braganza.
It is the combination of the call premium, the coupon and the principal that is key to returns, adds Braganza. "I have to see I am getting my coupon, I have to see that I am going to get my principal back in two years and I have to see I am getting my call premium – they are my return components," she concludes.

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