SEPTEMBER 2021

J O Hambro Capital Management Group

GLOBAL VALUE AND INCOME DISPATCH

"It's always a good time for income"

- When rates are low (and probably going up) and spreads are about as skinny as they have ever been, where does a credit investor go to make returns?
- Returns driven solely by holding a credit instrument to maturity are likely to lack luster if interest rates do rise – that's why we have recommended keeping durations short.
- Fortunately, we have a playbook for finding excess returns in a low yield environment.

Credit Market Update

It would be nearly impossible, or at least impractical, to recount all that has occurred in markets over the last 18 months. Even limiting oneself to credit markets, the task would perhaps be both exhaustive and exhausting. Since a picture is worth a thousand words, here are two that might adequately do the job:

Source: Bloomberg.

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The very short version is that interest rates are very low and credit spreads (exemplified by the US high yield index) are very tight. As an investor friend of ours is prone to say, though, "it's always a good time for income." However, when rates are low (and probably going up, see our last commentary) and spreads are about as skinny as they have ever been, where does a credit investor go to make returns? Returns driven solely by holding a credit instrument to maturity are likely to lack luster if interest rates do rise – that's why we have recommended keeping durations short. Fortunately, we have a playbook for finding excess returns in a low yield environment: we look for value-driving events.

Credit events are scary… usually

The nature of credit investing is dealing with the fundamentally negatively skewed distribution of returns. In essence, if one were to purchase a bond and hold it to maturity, the absolute best case is that one makes the yield to maturity at purchase.

Almost any other outcome will be somewhere from bad to worse. A graph showing the distribution of typical credit returns will show that most individual credit investments make a small positive return but that the tail extends much further and fatter to the left (bad outcomes) than it does to the right (great outcomes). As many who have heard us speak on credit investing will have already heard – when you wake up in the morning to a surprise in a credit portfolio, it's nearly always bad.

We are perpetually searching for ways to create positive optionality in our credit portfolio, and over the years we have accumulated a few areas for hunting. Here we describe a few of them:

1. Realization of organic credit improvement- this is the most common way credit investors look to outperform. Find a company whose credit metrics are improving, either because cash flow is growing faster than the debt, debt is getting paid down, or (most commonly) because they are about to get upgraded by the ratings agencies. The search for yield in 2021 by many market participants has focused on trying to find those "rising stars" which are likely to get upgraded from high yield to investment grade. The resulting technical demand for those bonds by managers limited to investment grade issuers is often enough to move bond prices substantially. One name we believe fits squarely in this bucket is Netflix. The company has indicated that they are likely to break even on a cash flow basis this year and be self-funding from here on out as their scale has finally reached a point where it fully supports their content development ambitions. Going forward, the company expects to maintain or slightly reduce its current quantity of debt, which implies substantial deleveraging as EBITDA continues to grow. The rating agencies have already indicated that if the company is able to meet its stated guidance, an investment grade rating will be appropriate. Once upgraded, the company will have better growth prospects, leverage, scale, and be years ahead of many investment grade competitors who currently enjoy significantly tighter credit spreads.
2. Early debt redemption – many high yield bonds are callable before maturity. Typically, there is a schedule of fixed premiums the company must pay starting with the first call date a few years after the issue date (usually with descending premium every year thereafter). However, before this schedule kicks in, the company is able to prepay the bonds at a price that equates to a fixed spread (often 30-50bps depending on the specific contract) over the relevant treasury security to the earliest call date. This price can be expensive and a company is usually incentivized to call the bond early only if they can issue new debt to refinance the old debt at a substantial interest savings that is enough to outweigh the large penalty. Given that high yield coupons are near all-time lows, this math favors early redemption more commonly now than in the past. We have assembled an allocation of high coupon bonds with relatively near-term call dates where it is likely in the company's interest to pay the extra "make-whole" premium by calling the bonds early.
3. Convertible bonds – a strong economy is likely to drive rates higher, but it is also likely to drive stock prices higher. We are always searching for convertible bonds with attractive yields issued by strong credits where the stock is significantly (though not impossibly) out of the money. If we can find one of these where we think the equity is mispriced, even better. While this type of security is always an important hunting ground for us, it is especially so during market environments like we have today.
4. M&A – the world of event-driven investing is permeated with managers attempting to identify companies who may unlock strategic value through corporate actions: spin-offs, mergers, and acquisitions are just a few of the most common transactions. Often there are significant opportunities to capitalize on these same events in the credit market, though many event-driven investors are more focused on the equity side of the ledger. Our team has substantial experience in the event-driven space and we are constantly in search of good credits that have not priced in the optionality of any such event. As an example of a current holding along these lines, one high-yield issuer in the healthcare space has announced a pursuit of strategic alternatives for one of its two lines of business. The natural assumption was that this business would be spun out, because market comparables trade with much higher multiples than the consolidated business. The most likely outcome is that the division is spun, it takes on slightly more leverage than the consolidated business (due to its higher enterprise value multiple), and the rest of the business uses the proceeds to de-lever modestly. That would be a fine outcome for the existing bonds. The founder and current head of this division has an exemplary reputation and would be well-received as a public market CEO, but after three months of the strategic review process, she announced her retirement. Combine that data point with some repeated corporate jet travel to visit potential investment grade acquirers of the entire company, and the event distribution looks very different. The high yield market has not at all incorporated that these bonds may turn into investment grade obligations overnight – an outcome that would cause significant spread tightening and therefore cause the bonds to rally materially. While this is still not the most probable outcome, perhaps one morning we wake up to some very good news.

The right tool for the job

Just like certain maths problems require different strategies to derive the right answer (don't ask us to relive integration by parts), certain market regimes require different tools from the toolbox to find outsized success. Our team has a diverse set of investing backgrounds, each bringing unique insights and problem-solving techniques to the table. We aim to understand each company in the context of its industry; to analyze the capital structure in its entirety; and to determine the best balance of risk and reward. In short, we aim to use the right tool for each job. If we succeed in this endeavor, then perhaps my friend will be right: it IS always a good time for income.

JOHCM Global Income Builder Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.08.21	31.08.20	31.08.19	31.08.18	31.08.17
A USD Class	16.37	4.63	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in USD net income reinvested, net of fees as at 31 August 2021. The A USD Class was launched on 4 April 2019. Performance of other share classes may vary and is available on request.