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INVESTMENT NOTE **24 MARCH 2014**

Around the world with Hermes Credit

Fraser Lundie, Co-head of Hermes Credit and Manager of the Hermes Global High Yield Bond Fund gives a credit 'world tour', providing an overview of the debt markets in the US, Europe and Emerging Markets, and revealing where the Hermes team are currently finding opportunities in each region.

United States

Fundamentally, there are a lot of good reasons to support credit in the US. GDP growth is at – or potentially above – trend, earnings are continuing to be strong at corporate level and balance sheet health remains in good shape.

However, we have some issues on the valuation side, particularly in sectors where the line is being crossed in terms of what is good for credit versus what is good for equities. Areas like energy and communications are examples of sectors doing more to benefit shareholders at the expense of bondholders. These are actions such as heavily debt-funded M&A, increased levels of growth capex, as well as special dividends.

Across both investment grade and high yield in the US, the most important aspect at the moment is to manage interest rate risk appropriately – given the potential effects of Federal Reserve tapering. Many people suggest the best way to mitigate interest rate risk is by either moving into short duration, or by moving lower down the credit risk spectrum. We see this as too narrow of an approach. In an already illiquid market, it compounds the issue of crowded trades and concentration of positions. Credit curves are near decade steepness and the pick-up in spread to go from BB to CCC is at pre-crisis lows. This is not the time to go with the herd.

We actually like taking on 'up in quality' trades, favouring BBs in high yield versus the lower end – while also favouring the long end of the credit curve versus the short end. This positioning is against the growing market consensus. It obviously leaves you with the potential for more interest rate risk, because this part of the market is more exposed. We mitigate this by either buying the bond and hedging with futures – or sell CDS instead of buying a bond, which incurs no interest rate risk. We are looking to achieve similar levels of interest rate risk mitigation as the wider market, but with a higher quality bias.

A good example of this can be seen in our position in **US Steel**. From a fundamental perspective, the company should deliver substantial cost savings in 2014 – which should drive EBITDA up 35-55% year-on-year. On the fourth quarter call, management outlined $500m in year-on-year cost improvements – including lower coal prices, reduced pension expenses, lower maintenance costs, and efficiency gains. EBITDA was $840m 2013 and current EBITDA estimates for 2014 are averaging $1.27bn.

We are accessing **US Steel** credit risk via 5-year CDS. In addition to avoiding unwanted US interest rate risk, this benefits from a 75 basis point pick-up in spread over the cash bond curve, as well as avoiding entering a position significantly above par and selling a very expensive call option to the company too.

Europe
Europe, particularly in southern areas, is the opposite of the US in some ways – with corporates still behaving with bondholders in mind. Instead of focusing on near term share price aspects such as M&A – corporates are trying to retrench balance sheets, term out debt maturity profiles and prioritise credit ratings. However, much of this is now priced in given the outperformance of Europe versus the US over the past 18 months. Many of the strong fundamental reasons to favour Europe are already displayed in the price.

However, we are still finding pockets of good value, such as recent German issuer **Lowen**. A private operator of arcades in Germany, Lowen has been in the business for 30 years and operates 316 gaming locations. The company benefits from low leverage, good free cash flow generation and consistently high margins. In addition, the recent deal was structured to ensure bondholders are attractively compensated should the company perform, avoiding a lot of the shareholder friendly 'leakage' that has become prevalent in other areas of the high yield market.

Emerging Markets

There is value on the cusps of emerging markets, particularly in higher quality countries and corporates. These are global business operations, with large capital structures. As many of these companies are exporters, they are benefitting from emerging market currency weakness. We are noting quite a lot of value in these types of companies.

For example, cement giant **Cemex** and petrochemical company **Braskem** have the same end markets as global competitors, but are headquartered in Mexico and Brazil – whereas close competitors might be domiciled in Germany or France. The business profiles and geographic exposures of these companies are comparable, but performance is being overly hurt by the perception of being from the emerging markets.

Other areas credit investors must consider

Dangers of traditional risk mitigation

There are two dangers to the more generic interest rate risk mitigation solutions. Firstly, valuations between short duration versus long duration is at its most expensive for more than five years – the In addition, the step up in spread to go into lower in credit quality is at its lowest since the crisis.

Secondly, when volatility spikes up in high yield, there is a much greater premium attached to liquid instruments and there is a growing consensus as to where to be in this scenario – such as short-duration, Bs, CCCs. This means there is a growing risk of crowded trades.

Beware bonds trading above call prices

One of the largest mispricing in the market at the moment is call risk. One of the main differences between CDS and bonds is that an investor is not selling a call option to the company by accessing credit via CDS. This is particularly important currently, as we are seeing many bonds trading above call prices. This puts a ceiling as to where things can go. Essentially, people are not pricing in call risk effectively enough. This makes the bonds that are not callable or CDS – which do not have call options – more attractive.

Default risk has lost importance

Default risk is very low and will continue to be very low for at least the next two years. Traditionally, default risk is the main driver of high yield returns; but it is not in today's markets. The main driver of performance is duration risk, convexity risk and volatility and liquidity risk. This means picking the right company is not necessarily going to guarantee returns. It is more important to pick the right security.

-ENDS-

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Notes to Editors:

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- Our **Multi-Boutique Structure** gives institutional and pension fund clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.
- Our **Investment Office** is a crucial function, acting as a performance risk 'radar' for all boutiques' investment activity and is central to our mission to deliver Sustainable Risk-Adjusted Alpha to all our clients.
- Our commitment to behaving as a **Responsible Asset Manager**, not merely by being a 'Responsible Investor' in quoted companies but also by applying these principles across all asset classes and by behaving as a 'good fiduciary' on behalf of our clients.

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