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INVESTMENT NOTE **04 MARCH 2014**

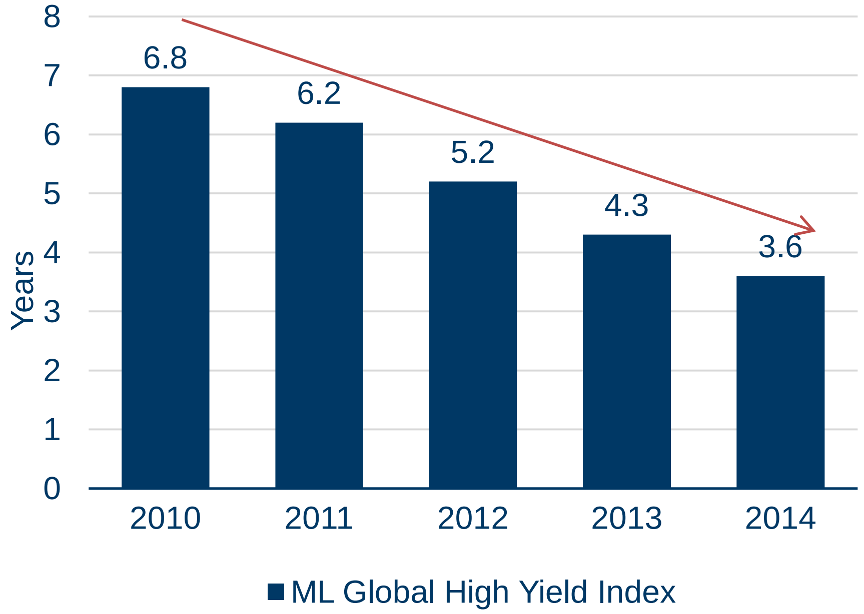
Dude, where's my upside?

Equity-like returns from the high-yield market may be history if certain deal terms – which are prevalent in new bond issues – become the norm, say Mitch Reznick and Fraser Lundie, co-heads of Hermes Credit.

Amid strong investment flows, record issuance and reduced default risk, something valuable is being lost in this, the most recent of high-yield credit booms. In a quiet evolution of the market, gradual changes in bond documentation are threatening the equity-like returns at half the volatility that investors seek from the asset class.

The iterative erosion of call protection, which shields investors from interest-rate movements before a bond's call date, is among the most dramatic changes in this structural creep. Call protection, which takes the form of a non-call period, guarantees that a bond cannot be refinanced within a specific number of years, typically starting from the date of issuance. This benefits investors in a rising-rate environment and extends the period in which they can be exposed to the price gains of well-performing credits – and therein lie the equity-like returns that investors have come to expect. However, recent demand for short-duration debt, combined with an undersupply of new issuance, has allowed companies to bring forward the dates at which they can redeem bonds. Since 2010, non-call periods worldwide have almost halved from 6.8 years to 3.6 (see figure 1).

Figure 1. Lost upside: average non-call periods are diminishing worldwide.

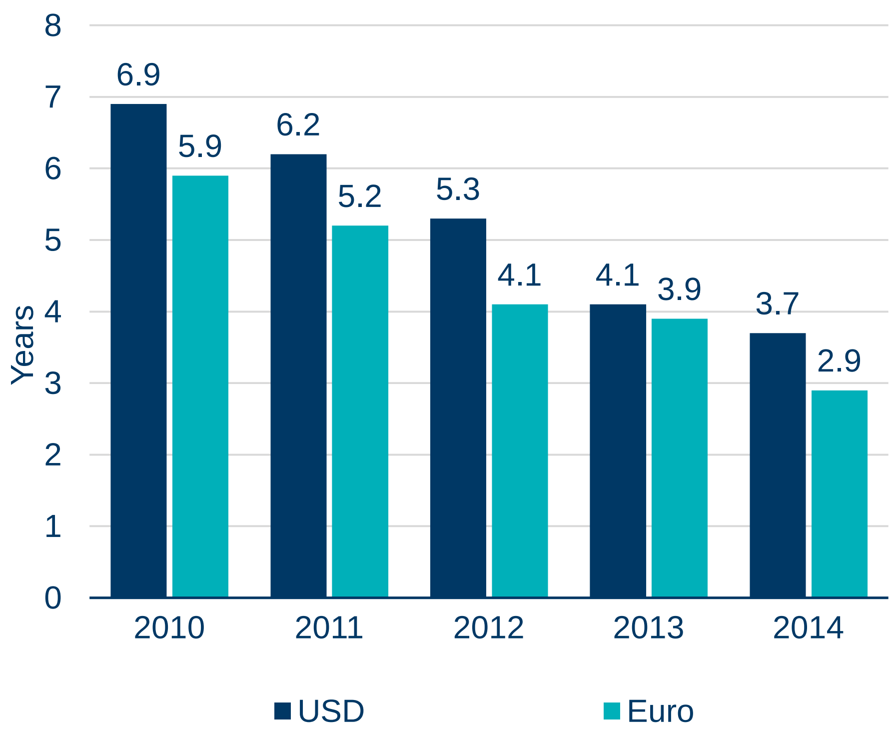


Source: Bloomberg

Fearing a spike in interest rates, investors have allocated heavily to short-duration credit. This has allowed companies to set closer call dates – a sign that issuers are winning the power struggle with investors over terms and pricing.

This is particularly evident in Europe, where banks' retreat from business-lending has fuelled the high-yield market but also resulted in companies applying loan features, such as closer call dates, to new bond issues (see figure 2). Europe has also been a fertile market to plant the seeds of other deal features that limit upside. To name just a few, these include payment-in-kind notes issued by private equity firms enabling them to extract cash from investments without listing them; special calls, in which companies embed the option of redeeming 10% of outstanding debt at 103% of par each year, and the increase in size of "equity claws".

Figure 2. Non-call periods are shortest in Europe



Source: Bloomberg

Special calls, equity claws

Diminishing non-call periods are not the only threat to equity-like returns from high-yield bonds. Over the past 12 to 18 months, a so-called "special call" feature has been written into new issues allowing a company to redeem 10% of outstanding bonds at 103% of par. This means part of the overall issue can, in fact, be redeemed during the non-call period.

This feature was embedded in 24 issues, comprising a total value of $11.3 billion, during 2013 in the US alone – an increase from the $8.4bn of such deals in 2012, according to market data and news service LCD. While it is not unique to senior-secured issuance from a company, it is more common of bonds that sit at the top of the capital structure with (or instead of) bank lenders. This feature reveals that the spectre of bank- and bond-market convergence is among us.

This enables companies to redeem debt to their advantage. For the bond investor, it creates a headwind for securities to outperform. It has become a fairly common feature in dollar- and euro-denominated bonds issued by Liberty Global's cable businesses, which include UnityMedia, Virgin Media and UPC. We see it in bonds with five-year non-call periods, but in the case of Serbia-based cable company, SBB/Telemach, the special call is embedded alongside a short, three-year non-call period.

In 2014, Poland-based wireless provider, Play, issued a senior secured bond with an even shorter non-call period of two years. The bond documentation also provided the issuer with an unusually large equity-claw feature. This allows the company to redeem 40% of the bonds at a typical rate of par plus 100% of the coupon in the event of an initial public offering. While the equity claw itself is not a new feature, it has historically been pegged at 35%. Play is not the only company to exceed this. There is a risk that equity claws of 40% will become the norm: if this happens, a greater portion of bonds can be taken from investors if the feature is triggered.

Collectively, shorter call periods, special calls and increased equity claws all put pressure on the ability of high-yield bonds to generate the performance that investors expect.

Short changed

This structural creep in bond terms threatens the historic risk and return characteristics of high-yield bonds. With more securities subject to shorter non-call periods, more of the market is structurally constrained from capital appreciation. Achieving long-term, equity-like returns with less volatility is more difficult. For instance, last year the US high-yield market returned 7.4% as the S&P500 index surged 30%.

As noted above, short-duration bonds have grown in popularity, in turn driving demand for shorter-maturity bonds, which have shorter non-call periods. Large short-duration funds, which are increasingly dependent on the primary market as a source of liquidity, have become forced buyers of the new issues featuring shorter non-call periods.

Reclaiming upside

To counter smaller non-call periods, investors should reduce their dependence on new bond issues and exploit other sources of liquidity. This can be achieved by investing worldwide, including in emerging markets, and searching throughout the capital structures of issuers to determine which bonds and debt instruments, such as credit default swaps, offer superior relative value.

If the market is going to concede the structural creep described above, then it should at least be sure that the increased optionality being claimed by issuers is priced into deals.

Ways of managing interest-rate risk that do not involve the short-duration market should also be explored. Using government bond futures to hedge positions is a liquid way of stripping out rate risk. This technique is widely used by investment-grade bond managers, but not their high-yield peers as there has been no previous need. Investors should also consider selling credit default swaps as a means of gaining long exposure with immunity to rate risk.

We also think that, at the moment, the market overemphasises company selection at the expense of managing fixed-income risks such as duration, convexity, volatility and liquidity. Given the substantial decline in default risk, stock-picking alone cannot generate consistent outperformance: traditional fixed-income abilities are also needed.

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Notes to Editors:

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