Positioning the portfolio amid recession fears

In late April, Tell Media Group, in cooperation with **Jupiter Asset Management**, **PGIM Fixed Income** and **Royal London Asset Management**, organised a roundtable discussion at Hotel d'Angleterre in Copenhagen with Danish investors, focusing on high yield bonds. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: **Niklas Tell** Photo: **Christer Salling**

The discussion started out with Caroline Liinanki asking the investors about their current exposure to high yield and how the allocation has changed in recent years.

ANDERS ELLEGAARD: "We have a strategic allocation to high yield and we believe it brings value to a diversified portfolio. Since I joined Industriens Pension some six years ago, we've slowly moved some of our high yield exposure to alternative credit as we've found the risk return profile more attractive in the illiquid part of the market. This has meant that we've moved from an allocation of some 7 per cent of assets to some 4 per cent today."

THOMAS WALTHER JØRGENSEN: "We also have a strategic allocation to high yield and as of today, we have some 3 per cent of AUM allocated. We've also increased our allocation to private credit over the last couple of years but not at the expense of high yield. We view private credit as an attractive supplement to a diversified credit portfolio."

NIKLAS TELL: ANDERS, ARE YOU STILL HAPPY WITH THE SHIFT FROM HIGH YIELD TO ALTERNATIVE CREDIT?

ANDERS ELLEGAARD: "We're still happy with that move. That said, we've always had exposure to high yield and it probably doesn't make sense to reduce the exposure further. It's more liquid and we need to have some liquidity in all our asset classes."

NIKLAS TELL: JONATHAN, WHERE DO WE STAND RIGHT NOW WHEN IT COMES TO OPPORTUNITIES IN HIGH YIELD?

JONATHAN BUTLER: "I would say the answer will depend on the timeframe. On the positive side, there's yield in the high yield markets again. In Europe, we had a 4 per cent yield at the beginning of last year and that's now 8 per cent so that's clearly better. That said, there are obviously some global economic threats out there, including the risk of recession. In the short term, we expect to see more volatility but as an active manager, we think it will be an interesting time going forward as we will see more dispersion."

ADAM DARLING: "I agree. I think it has been a volatile market for the last couple of years. We had extreme stimulus during Covid and now markets are starting to figure out what the end of that will mean for risky assets and high yield is part of that discussion. We think we will go into a recession and the repricing in markets from the yields we used to have to the yields we have today causes stress for certain companies. I agree that this should be a good market for an active manager. If we do our job well, we should welcome increased volatility and we should welcome a higher level of defaults because that provides more opportunities."

NIKLAS TELL: IS THE MARKET OVERALL PRICED AS IF WE WILL HAVE A RECESSION?

ADAM DARLING: "I would say that high yield credit spreads are not. Jonathan mentioned that we've seen volatility and in the middle of last year, Europe was priced for an apocalypse. Right now I'm surprised at the complacency around some areas of the market because there are a lot of risks out there. Our view is that we will move into a recession as the year progresses and we therefore need to ask if there's enough margin of safety in what we're buying."

JONATHAN BUTLER: "I think there's too much belief in the ECB and Fed being able to engineer a soft landing and avoid recession. They only have one tool. They don't have a steering wheel – they have a hand break and that makes it challenging. The markets hope that the central banks will pivot before we reach a recession but if you read what they're actually saying, they are very much focused on getting inflation under control."

AZHAR HUSSAIN: "I very much agree with what has been said already. From a traditional credit cycle point of view, we're late stage but there are a few differences compared to history. We've had a cleansing in the public markets during Covid and that puts high yield from a fundamental perspective in a much better place if we're going into a recession. That means that we should be fairly confident that defaults will be lower compared to history. The quality of the companies is better, there are more double B and less triple C companies and the equity cushion is bigger. It's a different market compared to what it used to be. What we don't know is the technical element. We don't know how markets will react. In the short term, we might therefore see spreads widening but long term I'm confident that high yield as an asset class should do pretty well."

ANDERS ELLEGAARD: "I agree with the long-term outlook but I also think that we're most likely entering a recession and from a technical point of view that will probably mean widening spreads. It's, however, a difficult thing to time so I wouldn't go underweight now because then you risk missing coupons and further appreciation. That said, there will probably be a point in time in the near future when there could be reason to add to your exposure."

THOMAS WALTHER JØRGENSEN: "I would say that high yield is a good asset class in general and the quality of companies issuing high yield is much better today compared to some 10 or 15 years ago. We have an allocation to both US and Europe and we don't see a need to change that. Today we have a neutral allocation and if spreads are widening significantly, we're in a position to increase that allocation."

CAROLINE LIINANKI: WHY SHOULD YOU HAVE A SPECIFIC ALLOCATION TO HIGH YIELD? IT'S AN INTEGRAL PART OF MOST DANISH PENSION FUNDS' PORTFOLIOS BUT THAT'S NOT NECESSARILY THE CASE EVERYWHERE IN NORDICS.

ANDERS ELLEGAARD: "When it comes to high yield, it's not about the yield but rather the excess spread that we can get over a business cycle. It's about excess returns. Then there can be diversification reasons as well."

PARTICIPANTS

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- **ANDERS ELLEGAARD**
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- **ADAM DARLING**
  Investment manager, fixed income, Jupiter Asset Managementi
- **JONATHAN BUTLER**
  Co-head of the global high yield strategy and head of the European leveraged finance team, PGIM Fixed Income
- **AZHAR HUSSAIN**
  Head of global credit, Royal London Asset Management

THOMAS WALTHER JØRGENSEN
Senior portfolio manager at Velliv with a focus on credit investment. He joined the pension company in 2018 from a similar position at Pensam. Before that, he worked as a credit analyst in the group treasury at DONG Energy. He started his career as a credit analyst at Skandiabanken.

ANDERS ELLEGAARD
Head of fixed income at Industriens Pension. He joined the pension fund in March 2017 and took on his current role in 2020. Before starting at Industriens Pension, he spent about 10 years in different positions at Nordea. He started his career as a risk specialist at Standard and Poor's.

AZHAR HUSSAIN: "You do, of course, get an additional yield in high yield but I think one additional thing to highlight is that it also has shorter duration compared to investment grade. And given where we are in the cycle, maybe that shorter duration should be of interest."

ADAM DARLING: "It does have a good sharp ratio but you can, of course, question if we have enough history. High yield is a good thing to have in a portfolio, even if you will see periods of volatility. It's an important building block, especially as the return is mostly income in the form of cash coupons over a cycle."

NIKLAS TELL: IF WE'RE MOVING INTO A RECESSION, WHICH EXPOSURES SHOULD YOU AVOID?

AZHAR HUSSAIN: "Commercial real estate is clearly a concern because of rising yields and also because of structural reasons from how Covid has changed a lot when it comes to for example office space. However, there's not that much direct exposure to that sector in high yield. I would say that in general, you want to avoid the areas that benefitted hugely from the stimulus over the last couple of years. Highly valued tech companies would be one example but they are also not really in the high yield space but rather in the US loans market. What's unusual with the high yield market today is that it's less cyclical than it used to be. It has become a more institutional market and a more investable market. The risks that we used to see in high yield have now moved over to the private market and that's where they should be."

ADAM DARLING: "As we're late in a traditional credit cycle, there are of course certain sectors that I keep a keen eye on, such as consumer discretionary that will not do as well if we're moving into a recession. But at the end of the day, it's about fundamental credit analysis. What's the quality of the business and the balance sheet? Will they have access to liquidity and capital and can management keep it together in a tougher environment? That's the benefit of being an active manager – we can look at this case by case. It can be a terrible sector but a great company but overall, I think this is a time when you need to be cautious."

JONATHAN BUTLER: "There's a cost-of-living crisis where everything is becoming more expensive and that's why we're all more cautious. The other thing is that the cost of debt is changing as well. Companies that were able to borrow at 4 per cent a couple of years ago are now having to refinance at 10 per cent. Here we have to do our research to understand if they have the balance sheet and the business model that's required to survive in this new world."

NIKLAS TELL: ARE THERE ANY DIFFERENCES FROM A GEOGRAPHICAL POINT OF VIEW?

AZHAR HUSSAIN: "The US market is more liquid. It's bigger and more diversified and that means better pricing in the US. That said I think the credit quality in Europe is probably better but we don't have as many players in the European market and it will therefore probably behave worse in a risk off environment. Fundamentally however there's no real difference."

JONATHAN BUTLER: "I agree that the US market is more efficient. Another difference is that the US economy is stronger compared to the European economy. That also means that rates are rising because of strong growth in the US whereas they're rising because of high inflation in Europe."

ANDERS ELLEGAARD: "I don't think anyone will be surprised if we are moving towards a recession. All active managers should be aware and positioned for it."

ADAM DARLING: "We read about investors being bearish but I don't see that being reflected in markets. That's a concern to me. I think markets can get very volatile if the economy gets worse from here."

> "That means that the credit quality of high yield has never been better than today and it also means that the credit quality of the leveraged loan market has never been lower"
>
> *– Jonathan Butler, PGIM Fixed Income*

CAROLINE LIINANKI: HOW DO YOU VIEW HIGH YIELD GOING FORWARD – BOTH VERSUS ILLIQUID CREDIT AS WELL AS VERSUS INVESTMENT GRADE?

AZHAR HUSSAIN: "If we take investment grade, that's just a pure play on interest rates. Your credit spread will not give you a lot of return. Private credit, on the other hand, is more difficult to pinpoint because it's a word for a lot of different strategies. Some of the smaller and more difficult issuers have disappeared from high yield and are now found in private credit. These are the ones typically running into problem and now we will not see that in public markets and that's great. We should, however, expect to see these defaults in private markets so there are hidden risks in private credit."

ANDERS ELLEGAARD: "I agree with that. It makes sense to have the riskier names in the private space because there you will have three or four lenders and then it's easier to agree on a solution if something goes wrong. It's more challenging when you have hundreds of investors trying to find a solution in a syndication."

JONATHAN BUTLER: "We've absolutely seen a shift where the leveraged loan market has been taking issuers away from the high yield market. That means that the credit quality of high yield has never been better than today and it also means that the credit quality of the leveraged loan market has never been lower and we will see more defaults in the latter."

THOMAS WALTHER JØRGENSEN: "I agree with Jonathan's view on leveraged loans and furthermore, I think it's fair to say that there's a huge dispersion in the private credit market. You could see some of the worst deals but you also have managers that have excellent sourcing capabilities and are able to pick good ones."

ADAM DARLING: "A lot of the attraction of private credit was reaching for yield in a world with no yield. That meant they would take on more risk and underwrite deals that public market wouldn't take. Today, we get the same yield in senior secured bonds as some of the most speculative issues in private credit were getting in the bull market and it will be interesting to see what happens when some of those deals need to be re-financed or when some of those businesses run into problems. I would assume that for some there will be defaults and zero recovery. That said, there's still a lot of dry powder in that market."

NIKLAS TELL: ANDERS, COMING BACK TO WHAT YOU SAID ABOUT ALLOCATING AWAY FROM HIGH YIELD AND INTO PRIVATE CREDIT OVER THE LAST COUPLE OF YEARS. ARE YOU MORE WORRIED ABOUT YOUR EXPOSURE THERE COMPARED TO HIGH YIELD?

ROUNDTABLE – HIGH YIELD

ADAM DARLING
Investment manager in the fixed income team at Jupiter Asset Management. Before joining Jupiter in 2015, he worked at Barclays, focusing on natural resource investments. Prior to that, he held roles at Société Générale and Morgan Stanley.

JONATHAN BUTLER
Co-head of the global high yield strategy and head of the European leveraged finance team at PGIM Fixed Income. Prior to joining the asset manager in 2005, he was responsible for establishing and managing NIBC's third-party CLO asset management franchise. He has also held investment positions with Chemical Bank (now JPMorgan Chase & Co.) and Industrial Bank of Japan (now Mizuho).

AZHAR HUSSAIN
Head of global credit at Royal London Asset Management. He has 22 years direct experience of investing in an array of strategies across the global fixed income and leverage finance arenas. He trained as a chartered accountant with Deloitte before starting his investment career at Gulf International Bank in London.

> "The easiest way for a manager to beat the benchmark is to take on more risk and that works until it doesn't"
>
> *– Thomas Walther Jørgensen, Velliv*

ANDERS ELLEGAARD: "I agree with Thomas – you have to pick the right manager. I think some of the ones that have been pitching to us will not be there throughout this cycle. As the banks have been pulling away from the market and are not able to do as much as they did previously, some of the deals that would have been financed by banks are now done by private credit managers. It's about having a team that understand credit and can source the right deals and know what to do if things go bad."

NIKLAS TELL: WHAT ARE SOME OF THE CHALLENGES IN FINDING GOOD HIGH YIELD MANAGERS?

THOMAS WALTHER JØRGENSEN: "As with most active managers across asset classes, you will have high yield managers that perform well in some environments and less well in others. So you need to do your due diligence and really understand what they do. It also helps if you have internal risk systems where you can monitor the managers and get a close view of their investment style. The easiest way for a manager to beat the benchmark is to take on more risk and that works until it doesn't."

ANDERS ELLEGAARD: "One challenge when selecting managers is that we haven't had a default cycle for a very long time. You also have to remember that when doing historical analysis, the managers that have performed the best are probably the ones that have been taking the most risk. For us, it's therefore more important to focus on the philosophy and understand how they're constructing portfolios."

NIKLAS TELL: SO A RECESSION AND DEFAULTS WOULD BE GREAT FROM A MANAGER SELECTION POINT OF VIEW AS THAT WOULD GIVE YOU MORE DATA?

ANDERS ELLEGAARD: "I actually think it will be good for the economy if we see some defaults. There are a lot of zombie companies out there and it's healthy if the weaker companies disappear and the stronger ones can grow. That said, I obviously don't wish for defaults. But if there are no defaults, you might as well have a passive manager."

NIKLAS TELL: ARE INVESTORS FOCUSING ON THE RIGHT THING WHEN THEY'RE DOING DUE DILIGENCE ON HIGH YIELD MANAGERS?

AZHAR HUSSAIN: "I think so. Ultimately, what should count is philosophy, experience and style. Those are the things that are core to what we do. I also agree with Anders that we do want to see some defaults because credit selection is really important – it's what we do every day. If you're holding triple C today, I think you really need to justify that, whereas it was the right thing to hold in the middle of 2020. That's the benefit of public markets and being an active manager."

ADAM DARLING: "What I love about high yield as a manager is that it really rewards hard work. If you do the work and understand the companies that you're investing in, you can generate alpha. There are inefficiencies because rating agencies have a role that's too powerful and human psychology is very powerful. I think one important aspect for investors to look at is whether the team has the necessary resources. I run an investment grade fund as well and a lot of that are macro considerations. In high yield, you really need the analytical horsepower to understand the individual issuers."

CAROLINE LIINANKI: SO WHY ARE THERE A LOT OF HIGH YIELD MANAGERS THAT ARE UNDERPERFORMING?

THOMAS WALTHER JØRGENSEN: "It's very much about how good the manager is at doing the bottom-up credit analysis. Finding hidden diamonds to outperform the benchmark. That's more difficult that one might think."

ANDERS ELLEGAARD: "As we've already said, we've been living in an environment for a long time where idiosyncratic risks haven't been priced correctly. A manager can do the bottom-up analysis but instead of a default, the company they look at has been acquired, sending the bond back to par for example. I'm, of course, only looking at this from the outside."

JONATHAN BUTLER: "I think a lot come down to process and return targets. There are players in the high yield market that have promised double-digit yields and that will force you into the lowest part of the index and that will be more volatile. So a lot will depend on the return targets of individual funds."

NIKLAS TELL: WHAT ARE SOME OF THE MAIN ESG CHALLENGES WITHIN HIGH YIELD?

ANDERS ELLEGAARD: "One of the problems for us is that we need to document this, so getting ESG data in order to measure and report is key."

THOMAS WALTHER JØRGENSEN: "The big issue is data and here we have better data on investment grade compared to high yield and it's even more challenging when it comes to private credit."

ANDERS ELLEGAARD: "I agree on the data but it's getting better when it comes to private markets. Today, most direct lenders know the carbon footprint of their companies. The challenge now is getting the data into our systems in a way that works smoothly."

JONATHAN BUTLER: "Lack of data is absolutely one challenge. Some smaller issuers in the private space might be divisions that have been bought out from a large corporate and then they haven't had that central function to collect and calculate the data. Also, often the private equity sponsor are not willing to spend the money and then we need to remind them that their new fund is an Article 8 fund and that they need to do it. There's a lot of work to get the issuers to provide the data but it's coming. There are also differences between US and Europe."

ADAM DARLING: "I think from an ESG perspective as Europeans, we perceive an ESG mandate in one way but that's of course not the same globally. Also, if you look at investment grade, that's usually global companies and they know this data is important. For high yield that's not always the case."

CAROLINE LIINANKI: WHAT ARE SOME EXAMPLES OF ESG INTEGRATION THAT HAS HAD AN IMPACT IN MANAGING RISK?

"Politicians are dangerous for investors, so if I think it's a business where there could be political confrontation, I would be careful"

– Adam Darling, Jupiter Asset Management

AZHAR HUSSAIN: "If you look at historical frauds, it always comes down to governance issues where management is allowed to do things without checks and balances. That should automatically be a red flag and that's why governance has always been an important part of the credit analysis."

ADAM DARLING: "I think S is an interesting and complex part when you're doing your ESG analysis. It can be a political decision that close a business, which we've seen with sub-prime lenders in the UK. Or it can be that public opinion turns against a business and then it becomes very binary. As an investor, you must not be complacent and remember that high yield is about charging the right risk premium for the risk you're taking."

NIKLAS TELL: DO YOU TYPICALLY STAY AWAY FROM BUSINESSES WHERE YOU THINK THERE ARE THESE BINARY RISKS?

ADAM DARLING: "Politicians are dangerous for investors, so if I think it's a business where there could be political confrontation, I would be careful. Because of the convexity where your upside is limited but your downside is zero, it's about being greedy and chase the risks that you can understand and price but avoid or be careful when the risk is more binary."

NIKLAS TELL: LOOKING AHEAD, WHAT ARE SOME OF THE THINGS YOU WORRY ABOUT AND LOSE SLEEP OVER IN HIGH YIELD TODAY?

AZHAR HUSSAIN: "As high yield investors, we're paid to worry. We're focusing on the weaknesses and the problems in order to avoid defaults. There are obvious things to worry about such as a recession. When it comes to potential black swans, we know that the environment we've had for such a long time with zero per cent interest rates and a lot of liquidity can create events that we haven't thought about but it's by definition hard to know what that will be."

JONATHAN BUTLER: "There are clearly elevated tail risks out there such as the geopolitical uncertainties around Ukraine and Taiwan. However, it's difficult to manage your portfolio on a daily basis on these risks."

AZHAR HUSSAIN: "I think you need to differentiate between risk and uncertainty. Risk is what you know and can price, whereas uncertainty is those unknowns. You can manage your risks and you can deal with uncertainty by diversification but there's not much else you can do. If China invades Taiwan – how do you protect any portfolio against that?"

ANDERS ELLEGAARD: "One thing that I focus on is how businesses that have been used to zero per cent interest rates are able to thrive or even survive in this new interest rate environment. The commercial real estate market is one obvious area to keep an eye on."

ADAM DARLING: "I agree. That transition from zero interest rates to a world where there's a real cost of money is something I worry about. We're early in that process and I think a lot of people are a bit blasé about the effects. Maybe it's because individuals have locked in financing and businesses have bonds that have not matured yet. If yields don't fall, I don't think we will just be worried about China and Taiwan – then we will see some real challenges for the world economy. The ingredients are there but because the cake is still in the oven no one is seeing it. We've seen some small examples of trouble, such as a couple of US regional banks defaulting, but risky assets are still doing ok. Everyone seems to think that we can kick the excesses down the road because inflation will soon disappear and interest rates will come down again. If that works, that's great. If not, then we will be in trouble."

NIKLAS TELL: NOW THAT WE'VE COVERED POTENTIAL PROBLEMS, WHAT ARE SOME OF THE UPSIDES?

AZHAR HUSSAIN: "As I mentioned earlier, I think the underlying structure of the high yield market is as good as it has ever been. That's positive. There are a lot of good companies in there that are generating cash flows."

ADAM DARLING: "The biggest positive is, of course, that there's yield back in the bond market. It means that you're actually paid to be invested in the asset class today."