Markets & Investing Podcast

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Topic: High-yield bond markets, with AXA Investment Managers U.S.

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Transcript

Intro – Steve Junge

Hello. I'm Steve Junge, national sales manager for 1290 Funds. Welcome to the latest edition of our Markets & Investing podcast series, featuring Chief Investment Officer Ken Kozlowski. As we move into Summer, many investors are uncertain about the current outlook. Questions about banks, interest rates and the economy have served to cloud the forecast. In this call, Ken talks about all these topics with Mike Graham, head of high-yield bond investing at AXA Investment Managers U.S., and portfolio manager of the 1290 High Yield Bond Fund. I'm certain you'll find this information useful. Now, let's hear about what Mike has to say about balance sheets and the fundamental benefits of free cash flows and relatively low leverage—and why he's not as pessimistic as some other market participants.

Ken

Hi, everyone. Ken Kozlowski here. Thanks for joining us at the Markets & Investing podcast. It's July, and Summer is in full swing. At Equitable Investment Management, we are all-weather investors, preferring a sound, disciplined long-term strategy over chasing hot sectors or the latest trends. That said, our asset management team meets from time to time to discuss any current themes we see dominating the cycle. Recently, we've been hearing a lot about high-yield

bonds. Over the long run, high yield bonds can offer both income and some price appreciation potential, without all the risks of stocks. In today's market, dominated by relatively higher interest rates but a cloudy GDP outlook, high yield may be an especially attractive asset class to own.

Against this backdrop, I'm really pleased to introduce a member of the AXA investment Managers U.S. team, Mike Graham.

Mike is head of the U.S. high yield team that manages over $13 billion in high yield assets and is based in Greenwich, CT. He is a lead portfolio manager for several U.S. and global high yield portfolios at AXA IM. For 16 years, Mike has served a number of roles within the US High Yield team at AXA IM. He joined the portfolio management team in 2010, after starting out as a US high yield credit research analyst covering a number of sectors including utilities, energy and healthcare. Welcome, Mike.

Mike

Hi Ken, thanks for having me.

Ken

All right, so let's get started. So, first question: what are the potential benefits of investing in the high yield market and how can the opportunities in that market fit into the average investor’s portfolio?

Mike

Sure. So the high yield market today consists of approximately 900 issuers, all below investment grade ratings, so below triple B minus credit rating and have approximately 1.4 trillion of publicly traded debt. This market can provide a higher income stream and, subsequently, the potential for a higher return. When compared to the investment grade market today, the market yields a little bit under 9% compared to the investment grade market that is around 5 1/2%. So that’s an additional 300 to 350 basis points of yield that investors can earn. This comes with the higher potential of loss through defaults or through selling securities at significant losses. So as active managers, it's our job to go through and try to capture what is contractually obligated from these high yield companies to pay their coupons at attractive prices in today's market. By avoiding companies that will have trouble handling their higher interest expense. Overall, the market tends to be correlated with other risk asset classes. But it's important to point out that it typically experiences much better drawdowns and has a lower volatility than other equity markets. So all in, the market helps investors, whether it's institutional or retail, really increase the income stream of their portfolio. And depending on how it's mixed between equity

government bonds and investment grade. Can help to increase the return without really significantly adding to the volatility of the investor’s portfolio.

Ken

And how has the high yield market evolved over the years?

Mike

Now over several years and even decades, I would say the market has become an asset class that warrants more of a core position for all investors. Again, institutional and retail, as opposed to earlier in the life of the high yield market when it was used, I would say more tactically. In more recent years, the market has seen a dramatic shift higher in credit quality, particularly if you're comparing the market today versus shortly prior to the great financial crisis around the 2007-2008 time. Period and its moved up in credit quality, I would say in three different ways: First, over the last 10 years, we've gone through two default cycles, really, back in 2015 and 2016, where the market lost a lot of high levered energy companies through bankruptcies, and again in 2020 during COVID when the default rate moved up to just under 7% and really took out a lot of the higher levered, higher risk companies in our market, which was in a relatively recently time period. Second, around that same time period in 2020, during COVID, we saw a lot of fallen angels, or companies that were downgraded from investment grade, and these are companies, you know, where some of them have moved back up to the investment grade market in the past year. But others have settled out in that double-B category, and these tend to be larger, more predictable companies that people are familiar with. Lastly, I would say over the past three to five years, the leveraged finance market has evolved, and has really seen incredible growth in the U.S. leveraged loan market through collateralized-loan obligation (CLO) demand, and the US private debt market through institutional demand. And a lot of funding of what could be more risky LBO-type financings from private equity buyouts, a lot of their preferred financing has been in those other two markets. So in previous cycles where we've seen a little bit more higher levered companies as a greater share of the overall high yield bond market. Today it's a little bit less so because of that preference that private equity companies have over the past five years, the result in numbers today is that our market is over 50% double-B rated. That compares to about 40% double-B rated back in 2007-2008 time period, and triple-C's just make up around 11% compared to more of the 18-19% that we saw 10-plus years ago.

Ken

And what are some of the criteria that you consider when investing in the high yield market?

Mike

There are several different approaches to investing in the high yield market. You know the ultimate goal for everyone is to collect that contractual income stream and not give any of the return back through credit losses in defaults. But in general, I would say credit investors and high yield investors look at things like corporate leverage loan-to-value; or how much equity cushion, explicit or implicit you might have behind your bonds; top line and bottom line trends; free cash flow generation of the company; and also, for some investors, a focus on asset coverage or recovery in default. As an investor that focuses more on avoiding defaults as we are—rather than what recovery you would get—you know we tend to prioritize really five key criteria: The first, we're looking for predictable companies. The second, we're looking for companies that can have positive year-over-year growth projections. The third is companies that generate free cash flow. Fourth, companies that will use that free cash flow to improve the credit quality, or de-lever, the balance sheet. And fifth, companies that will have a high amount of corporate liquidity. We further enhance this with, you know, things like leverage metrics and credit ratings to determine what we think is the best relative value in the market.

Ken

You've written lately that you are less concerned about the impact of a possible economic downturn because of low debt levels on corporate balance sheets in general and high cash levels. But obviously the threat of defaults is on the minds of many high yield investors. What is your outlook for defaults through the end of the year, and what can high yield investors do to mitigate the risk?

Mike

Yes, I think it's fair to say that we've been slightly more optimistic than maybe others on the return potential of the high yield market, and specifically where default rates could go over the next 12 months. We started the year with our default projection at around 2% to 4% for 2023, and despite a lot of changes in the narrative in the market, we haven't adjusted that default expectation for this year. We use a bottom-up approach in trying to determine what companies and which issuers may default over the next 12- or 18-month time period. There are certainly some higher expectations out there, more often from strategists that use top-down macro driven models as opposed to our bottom-up style. So you know our optimism is more focused on really the specific high yield market today and the composition of the high yield market today because of that increase in credit quality that we just discussed. We're slightly more bearish—or let me say, less optimistic—on the default rates for the broader U.S. economy and particularly some other asset classes, whether it's leveraged loans or private debt, that might have a higher amount of floating-rate debt exposure. In our market today, we're actually still seeing the overall leverage, the average leverage, of the market declining. It's dropped recently to 3.9 times, as of the end of last quarter, however, we are seeing more divergence in recent

results in companies across different sectors, and we ultimately think the key to mitigating default risk over the next 6-12, maybe 18 months is monitoring companies' interest-rate coverage ratio, so definitely cash flow over interest expense, which we are coming into this environment at record levels, but we are starting to see a slight deterioration. Ultimately, our investment thesis is that the majority of the high yield market has plenty of time to adjust to this higher interest-rate environment. Remember, these are companies that put in place very low coupon debt at 8- to 10-year maturities over the last…call it, two years. In fact, we also think that there are companies that have a lot of free cash flow, that today are looking at their cap structures and realizing that the bottom line is that debt is more expensive. The capital structure that you would come up with today as the CEO or CFO is different than what you would have put in place when rates were lower in the 2020 or 2021 time frame. And so you will see some of these higher free cash flow companies, companies that own desirable assets or a desirable company themselves, look to ways to lower their the quantum of debt that they have, that can adjust for this higher interest expense environment, whether that's through accessing things like the convertibles market, preferred equity investments or even the equity market—if that starts to pick up, and starts to open for secondary issuance. There are things I think we can be positive about in this market. I think we're finally in a market that encourages management teams to deliver and improve the credit quality; but there are risks, and I think ultimately we're most concerned about the highly levered issuers with a high amount of floating-rate exposure in their cap structures, that will find it difficult to access other non-cash-paying interest capital to help them adjust, and make it through this period of higher interest rates.

Ken

Can you spend some time on how you adjust the portfolio to account for market uncertainties? For example, how do you make it more defensive or for that matter, more aggressive?

Mike

Ultimately security selection is key. Our investment style and philosophy has its advantages, particularly during times like these when there's economic uncertainty or companies, you know, facing higher costs. But, over the past year, focused on security selection, we have had the mindset of underwriting and constructing a portfolio by asking: will these companies be able to handle a mild recession, on one hand; and on the other hand, be able to manage an economy that keeps moving along strongly, but is a higher interest rate environment. And so that has, you know, had an impact in the securities that we've selected and the issuers that we're sticking with. But ultimately, I think security selection will be key. A lot of people say it's a credit pickers market and, in times like this, we would agree with that. We also have a top-down influence to our portfolios in terms of how we construct the portfolio, and we can do that in a few different ways. But you know, overall, we're looking at the level of risk we're taking in terms of, you know, simply looking at credit-rating risk, double-Bs versus triple-Cs within the portfolio, relative to the index. You can also look at it from the sector focus, and also the amount of names that we own

that have higher leverage. But we also adjust the level of duration of the portfolio, versus the index. And ultimately, you know, when yields are much lower or spreads much tighter, we tend to lower the duration of our strategies, which helps us outperform if we see any potential volatility. When times are much more attractive with higher yield, we tend to have a duration that's more in line with the index and the yield more in line with the index. Today we're more in the latter stage of portfolio construction. We feel the overall market is attractive. But we are still a little bit hesitant to add more credit risk and be overweight credit risk until some of these economic uncertainties play out.

Ken

Mike, last question: So traditionally high yield funds have tried to offer a little bit more total return than investment grade funds with a little less risk than stock funds. Compared to, say, stocks or investment grade bonds, what potential benefit does a high yield strategy offer investors when the economy is in positive territory as it is today, but the outlook is uncertain?

Mike

Right. I mean I think maybe two things to note there. I think the market from our perspective is always uncertain, right, but the degree to which investors are talking about that uncertainty will change from time to time. But there's always a level of uncertainty. And secondly, in today's market, with today's uncertainty, it is much easier to deal with that type of unknown when you're having a high yield that yields, you know, close to 9%. Right? I always say that, the more difficult time to invest in high yield is more like around that 2021 time period, when the yields dropped below 5%. You don't have as much current income to offset any of this potential headline risk or uncertainty risk, as opposed to today's market where you can offset any type of volatility with that higher income stream! So I think there's a lot of attractive things for the overall market, I think, a ton of bottom-up opportunities that we see to invest in, that are companies that are still performing, you know, quite strongly. Ultimately, the high yield market does better in steady economic environments, but importantly, when compared to equity markets, it doesn't need growth, doesn't need a significant amount of growth and, in fact, a good portion of the market, the double-Bs that are more rate sensitive, will probably rather prefer not having a lot of growth, right, because you don't want rates to continue to move higher. So ultimately, I think what you're rooting for, for the high yield market—and when it does really well, in a “Goldilocks” scenario—is a low growth environment, where companies can address their coupons, pay down their debt and really provide attractive returns for investors.

Ken

Mike, thank you so much for your time and for your insights. It was really a pleasure being with you today. Thanks again.

Mike

All right. Thank you, Ken.

Close – Steve Junge

Hello again, listeners. Steve here. We hope you enjoyed the discussion and are armed with a better understanding of how high yield bonds may fit into an overall investment allocation. AXA IM's strategy is available in various Equitable variable life insurance and variable annuity products, in our mutual funds and our investment model portfolios. Interested? We encourage you to log on to 1290funds.com to take a look at the mutual fund prospectus, or equitable-funds.com for information about variable insurance underlying portfolios. For now, have a great day and let's plan to keep these discussions going throughout the coming months.

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