Broader horizons: The evolving high-yield landscape

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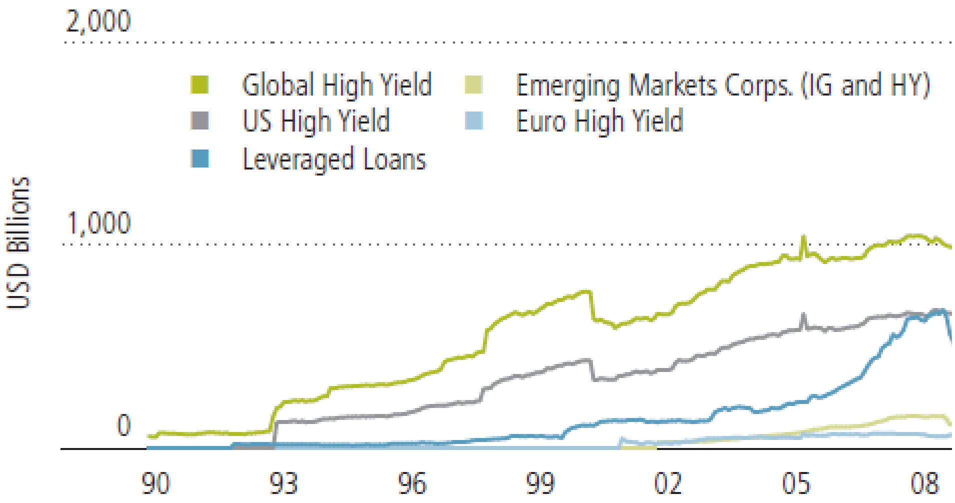
Over the past 40 years, the high-yield landscape has grown exponentially, offering diverse investment opportunities for investors and innovative funding sources for issuers. How can investors manage the major risks and capitalise on the potential rewards of an asset class that is increasingly complex, more regulated and continually evolving? Knowing the key risks and emerging opportunities – and understanding how different investment strategies can help crystallize investment goals – can help in mapping the path forward.

INTRODUCTION

The high-yield bond market has experienced extraordinary changes since its American inception. The US market has benefited from robust expansion over the past two decades. The European market has been rapidly growing and deepening in terms of industry and issuer diversification since 2008, driven by a surge in company downgrades and a transition from bank financing to capital markets. Emerging markets (EM) corporates have also become a more significant part of the high-yield universe over the past decade for a variety of reasons, namely diversification of funding sources, companies gaining the scale to access the bond market, and issuers' preference for the longer tenors and unsecured nature of the bond market.

While the US is still dominant, accounting for roughly 75% of the global high-yield bond market in 2013, Europe has expanded to 18% of market share and EM has increased to 7%. The fledgling market once confined to US shores has clearly become more expansive, mature and established. Figure 1 illustrates the global high-yield market's dramatic growth, by market value, from 1990 to 2013.

Figure 1: The high-yield market has experienced substantial growth
To 31 May 2013



Sources: Barclays, Credit Suisse, J.P. Morgan and AllianceBernstein

As a result of stellar growth, investors seeking high income or attractive total return can now find an extensive, global opportunity set of public and private credits that can be used in numerous ways to pursue diverse risk and return objectives.

This sea change from a high-yield market historically dominated by US corporates to a much broader investment spectrum is exemplified by four growth areas that are compelling:

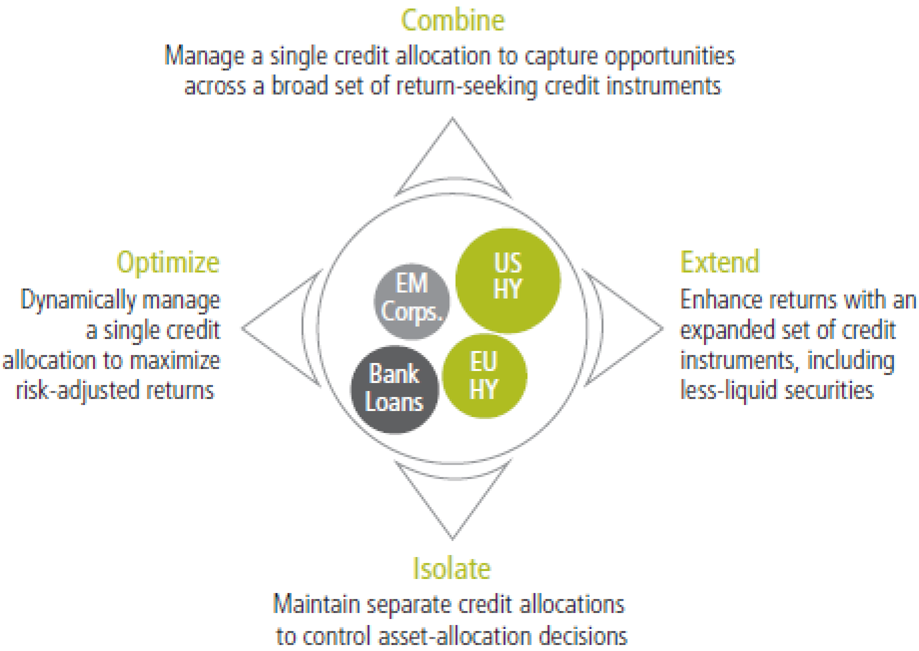
- European high yield
- Global financials
- EM corporates
- The mainstreaming of the private credit market

All four illustrate how the nature of the asset class has shifted to a high-yielding global opportunity set.

While the high-yield complex now spans the US, Europe and the emerging markets, there are common risk factors such as default and liquidity, that investors must manage - and, while common, these risks often vary by market and security type. The market has evolved to the point where investors can now focus or diversify these risk factors and beta attributes to meet a variety of investment objectives. The final section of this paper highlights four investment paths designed to provide exposure to specific types of risks and opportunities. The four directions of the "compass" are designed to provide a guide, enabling investors to orient to the path that best matches their asset-allocation framework and investment goals.

The divergent paths available can be summarised as Isolating, Combining, Extending and Optimizing (Figure 2). The journey to better outcomes might begin with an investment path that simply Isolates high-yield opportunities, such as EM high yield or US bank loans. An alternate route Combines high-yielding credits without sector constraints, with the aim of exploiting promising opportunities across a broad set of credits. Or, it may Extend to more complex and less-liquid sectors that feature private credit, which may offer an illiquidity premium. Lastly, an investor can choose the Optimizing path, which actively pursues attractive opportunities across multiple sectors with a focus on maximising risk-adjusted returns.

Figure 2: Navigating investment goals



Source: AllianceBernstein

To calibrate true north, and to put today's market in perspective, it's insightful to look back at how the market's structure has changed since the first flight to lower-quality assets.

HIGH YIELD 1.0: THE DAWNING OF A US BULL MARKET

Prior to the late 1970s, the vast majority of the high-yield universe consisted of fallen angels, previously investment- grade companies that had slipped to BB+ or lower. In the 1980s, the high-yield market boomed as more diverse companies with below-investment-grade profiles began issuing speculative-grade bonds - revolutionising financing for the marquee leveraged buyouts and other acquisitions that are often associated with investment banker, Michael Milken. As the market progressed, high-yield bonds became an accepted tool for financing balance sheets and corporate actions such as funding capital-intensive expenditures.

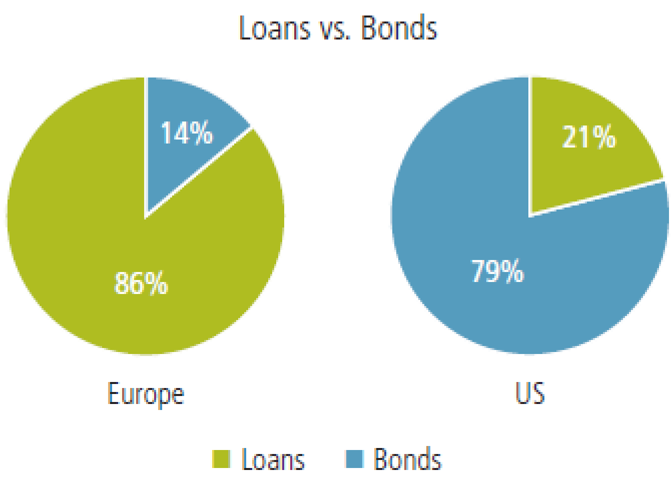
Investor appetite for high-yield bonds continued growing over time as the benefits became more apparent:

- The potential for higher returns than investment-grade bonds, which compensates investors for default risk.
- Lower correlation to most other fixed-income sectors.
- Similar return profile to stocks but with generally lower volatility.
- Greater liquidity than private placements.
- For insurance companies, a lower capital charge versus equities.

WITH CHANGE COMES GLOBAL OPPORTUNITY

Despite some fits and starts, the European high-yield market remained relatively small during the US boom cycle. Even with the introduction of the euro single currency in 1999, less than 1% of the corporate high-yield market was issued outside the US. Lending in the euro area is still heavily skewed toward bank syndicates rather than the bond market, given the long-standing legacy lending relationships between European banks and their locally domiciled corporates. As Figure 3 illustrates, the European market remains almost the exact opposite of the US market.

Figure 3: Europe has historically been financed by loans
31 December 2013



Sources: Haver Analytics and AllianceBernstein

Since the financial crisis, however, the European high-yield bond market has almost quadrupled in size. This has occurred for two reasons. First, well-known companies throughout Europe - many of them domiciled in the periphery - lost their investment-grade ratings in the aftermath of the global financial crisis and European sovereign crisis. Second, many junior subordinated bonds throughout Europe were downgraded to sub-investment grade. As a result of these events, there are opportunities among Europe's fallen angels. Additionally, the disintermediation of the banking sector is driving many new issuers into the European high-yield bond market, and outsized market growth is expected to continue as a consequence of ongoing disintermediation.

The global finance sector is another area that is promising. Specifically, in developed European countries, select financial institutions are compelling, as the junior parts of their capital structures contain subordinated debt that is often sub-investment grade. Accordingly, the European high-yield index now boasts a financial sector allocation of 22.8%, a tenfold increase from 10 years ago. By comparison, US financial-debt issues account for approximately 10% of US high-yield indices. Before the credit crisis, global financial services firms in high-yield markets were underwriters, liquidity providers and researchers - rarely did they take on the role of high-yield issuer or index constituent.

The increasing number of financial firms issuing subordinated financial instruments, and new securities such as contingent capital notes (commonly referred to as CoCos) will have a lasting impact and present significant long-term investment opportunities. This growing market segment is partially a consequence of the sustained need for increased Basel III-compliant capital instruments. Although we have already seen more than $140 billion of post-financial-crisis issuance across US bank preferred stock and European bank Basel III-compliant AT1 and other contingent capital securities, the authors estimate the likely growth of this market to be in the range of US$350 to US$400 billion. Investors who can navigate this increasingly complex area of the global high-yield market will likely find ample opportunities over time.

The high-yielding market in EM - wherein the vast majority of issuers are investment grade - began to emerge over the past decade for a number of reasons, in addition to those mentioned earlier. The strong tailwinds of the past 10 years - the substantial rise in GDP, the commodity boom, improved credit fundamentals, structural reform and the increasing evolution in the capital markets of select EM countries - helped lead to robust corporate issuance, establishing a corporate bond market that spans the entire credit spectrum, including subinvestment-grade-rated companies. The EM corporate bond market exceeded US$1.5 trillion in 2013.

Specifically within EM corporates, US dollar-denominated corporate bonds offer value. They often afford more yield per unit of leverage than do developed-market corporate bonds, and can represent exposure to sectors and business cycles that US and European firms may not.

As EM economies continue to evolve, the authors anticipate increased investor interest in local-currency corporates, especially in countries with strong growth projections and solid credit fundamentals. Additional complexities arise when analysing high-yield bonds issued by emerging companies, however, as sovereign risks can influence the performance of these investments. Consequently, EM corporate investing requires both bottom-up credit research and top-down country analysis.

Beyond the rapid growth and development seen in EM and Europe, the high-yield market overall has undergone an extraordinary transformation, with new investors, issuers, instruments, and the growing use of derivatives changing the nature of the asset class. Its scope now extends beyond US sub-investment grade bonds to diverse and global high-yielding instruments. These can include investment-grade and below-investment-grade securities, public and private credit markets, a corporation's entire debt and equity capital structure, and non-corporate instruments.

Analysing risk in subordinated financial instruments

Given the many changes happening across global high-yield markets, assessing and pricing risk now requires a thoughtful and thorough analysis of both familiar and, in some cases, far less familiar variables.

When thinking about subordinated financials in particular, it's not as simple as applying the same kind of analysis that is done on a typical nonfinancial corporate high-yield bond. For example, given that many of these instruments are coming to market as a result of regulatory changes, one of the most critical inputs into the analysis is an assessment of the prevailing regulatory framework. That is, do the instruments meet regulatory standards and requirements?

In addition, credit analysis of financials varies from the analysis of typical nonfinancial high-yield corporates in other ways. While always considering all the major facets of a credit, in analysing financial issuers, greater focus is typically placed on capital and liquidity requirements versus current income and cash-flow metrics, as financials, particularly subordinated financial paper, tend to exhibit more severe "jump to default" risk, in the authors' view. There are two components for analysing default risk in a security - the probability of default and the severity of default. Subordinated financial instruments, such as those being issued in accordance with Basel III, areintended to lower the probability of default, but they typically have high loss severity, which can be painful for investors if the issuer does in fact default.

HEADWINDS, SUPPLY AND DEMAND

Despite the depth and breadth of today's global high-yield market, there are imminent challenges, such as diminishing liquidity (Figure 4) caused by:

- Basel III - Holding large bond inventories is more costly and challenging for banks, which must now comply with more stringent international regulations. Consequently, since the financial crisis, transacting in bonds beyond the most liquid developed-government markets has become more difficult as broker-dealer inventories have decreased in size (Figure 4).
- The loss of three major broker-dealers during the financial crisis - Bear Stearns, Lehman Brothers and Merrill Lynch.
- A secular decline in the risk appetite of trading desks to take principal risk
- Similar to Basel III, Solvency II - Regulatory changes that could impact insurance company investments in high-yield debt.

Gershon M. Distenfeld, CFA, is Director High Yield with Alliance Bernstein. He directs all of AllianceBernstein's investment activities regarding high-yield debt securities across dedicated and multisector fixed-income portfolios. He is also a member of the Absolute Return, Global High Income and Global Credit portfolio management teams. Ashish Shah is is Head of Global Credit and a Partner at AllianceBernstein. He is also a member of the Absolute Return portfolio management team.
