HIGHLAND

INSIGHT
FEBRUARY 2016

TRUTH OR "UNINTENDED" CONSEQUENCES: THE STATE OF HIGH YIELD

It has been our view that the world is mired in a "Triple L" era: Low growth with Low yields for a Long time. This is caused by the Global Financial Crisis and the policy responses by central banks, venturing into non-traditional and untested policies. Their intent was to limit the pain the world was experiencing and restore growth. Rates were lowered to zero and quantitative easing was enacted. The objective was that the lowering of yields would push banks into lending and investors into riskier assets, thereby stabilizing capital markets and generating economic growth. Every decision in life has consequences. Some intentional and others unintentional. While capital markets did stabilize and economic growth began, the ensuing low yield environment provided for a perfect ecosystem for animal spirits.

With multi-year lows in interest rates, companies were incentivized to issue debt at lower rates, reducing their overall cost of debt. Essentially, the central banks intent was realized, lowering rates allowed corporations to repair balance sheets. This new debt issuance made its way into the hands of investors via corporate bonds issued by blue chip companies, a.k.a. investment grade, and more risky corporate bonds, a.k.a. high yield or junk bonds. Companies that issue high yield debt are typically smaller and/or more susceptible to the business and credit cycle. Because of this, investors demand a higher yield which historically has been approximately 400 basis points of additional yield versus investment grade.

Traditional buyers of high yield debt are investors seeking higher returns than bonds with lower risk than equities. These investors are usually aware of the additional risks born by these investments in order to generate higher returns. The low yield environment has changed the landscape for high yield bonds, forcing traditional conservative investors further out on the risk spectrum in order to generate needed returns. This unintended consequence broadened the investor base and exposed new investors to additional risks they would not normally assume or understand.

Taking on additional risks for more return is not a problem for most investors in a rising market, but can become very worrisome during downturns. From 2009 - 2013, high yield bonds returned 18.9% on an annualized basis, surpassing the S&P 500 at 17.9% and the Barclays Aggregate Bond index return of 4.4%. However, since October 2014 when the Federal Reserve ("Fed") ended its Quantitative Easing program, high yield bonds have declined by 6.4% on an annualized basis, which is much worse than U.S. equities (-1.0%) and bonds (+2.2%). Over that time frame, high yield spreads have widened 350 basis points, indicating that investors are demanding a higher yield over safer investments (see Figure 1).

With today's tumultuous environment, we are watching the high yield market with a close eye. With every drop in the equity markets or release of negative economic news, we ask: is it time to put money to work in high yield? Answering this question

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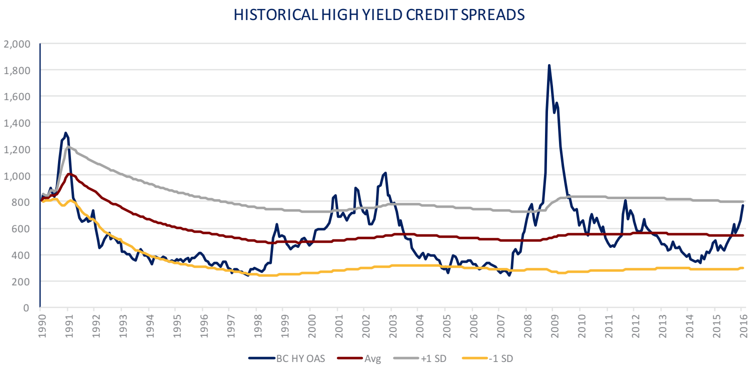
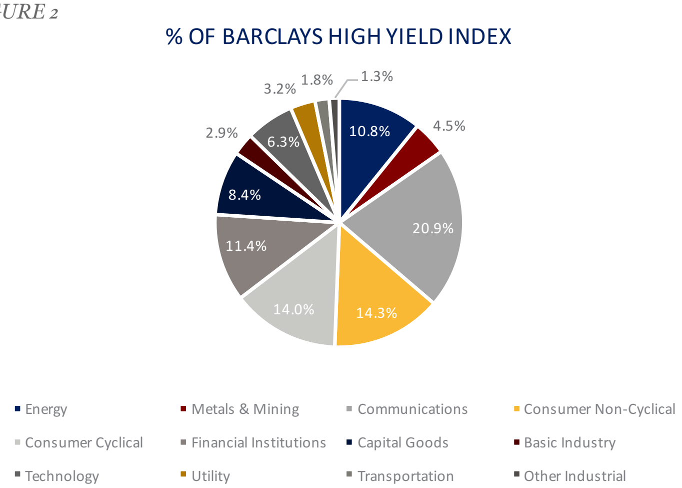
is challenging, as there is a large amount of "noise" surrounding this market. Specifically, the popular opinion is that the negativity is confined to the energy sector, so now might be a good time to buy these bonds. We don't invest on opinion, rather we look at the drivers of returns and the inherit risks as our guide.

FIGURE 1



SOURCES: BARCLAYS CAPITAL; HIGHLAND ASSOCIATES

FIGURE 2



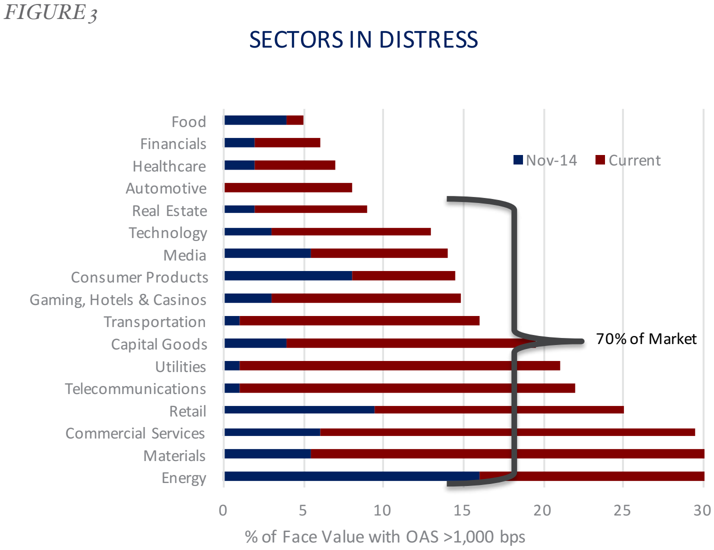
SOURCES: BARCLAYS CAPITAL; HIGHLAND ASSOCIATES

LIQUIDITY

While it is true that energy, metals, and mining comprise approximately 15% of the Barclays High Yield Index (see Figure 2), they are not the whole story. These sectors in particular are hurting from the drop in commodity and energy prices, which have seen prices fall over 50% the last two years. At the end of January 2016, these sectors credit spreads are trading at over 1600 basis points. This is double the overall index level and signifies the magnitude of stress in these sectors. When credit spreads trade at over 1,000 basis points (or 10%), they are considered to be distressed and they experience a drop in liquidity.

This decline in liquidity has many implications as to how these bonds trade and how this impacts other high yield sectors. When high yield bond prices first began to see credit spreads widen, the impact to investors was not as apparent as the bond yield more than offsets the price decline. However, as energy and commodities continued to fall, spreads widened so much that the entire asset class began to experience negative returns. This feedback resulted in investors selling high yield bonds. As bond managers had to meet redemptions and could not sell their distressed energy and mining bonds, they sold their most liquid names first. When outflows were manageable, bond managers were able to easily meet these redemptions. However, last summer as investors began to worry about China's future growth prospects, the U.S. dollar and the Fed raising interest rates too quickly, higher risk assets sold off more aggressively. Equity volatility rose, both U.S. and international equity markets corrected and high yield spreads widened. This time the sell-off was not confined to energy, metals, and mining, but was rampant. If we exclude energy, metals and mining, high yield bond spreads are trading at 670 basis points which is at levels last experienced during the Euro Crisis of 2011 and above their long-term average. In November 2014, only the energy sector was trading at distressed levels (see Figure 3). Currently, 70% of the sectors are now trading at distressed levels, or spreads above 1,000 basis points. Therefore, a large portion of the high yield market is suffering from illiquidity.

FIGURE 3



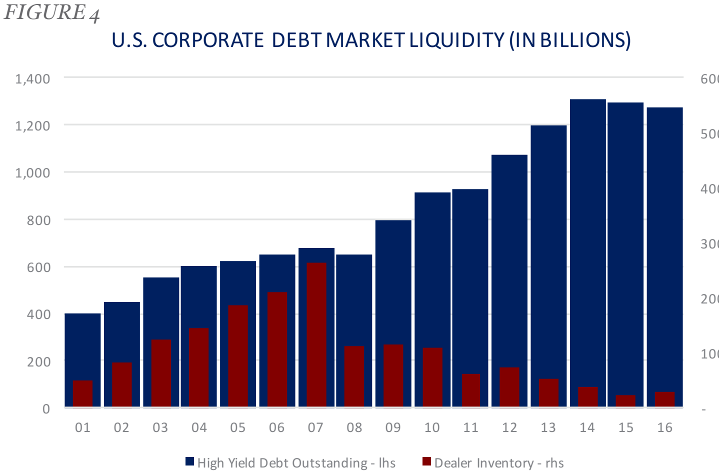
SOURCES: DEUTSCHE BANK; HIGHLAND ASSOCIATES

In 2007, corporate bond dealer inventories totaled $250 billion (investment grade + high yield). Today these stand at $30 billion (see Figure 4), a 90% decline. Meanwhile, the asset class has grown from $600 billion in 2008 to $1.3 trillion today.

CHANGES IN REGULATION

Before the Global Financial Crisis and Dodd-Frank, when investor liquidity dried up on high yield bonds, bond dealers would step in and provide liquidity. As the original underwriters of the bond, they understood the idiosyncrasies of these bonds and could hold it in their inventory while potential buyers analyzed the credit worthiness. However, the regulatory change brought upon by Dodd-Frank forced bond dealers to significantly reduce all of their corporate bond inventory, not just high yield. In 2007, corporate bond dealer inventories totaled $250 billion (investment grade + high yield). Today these stand at $30 billion (see Figure 4), a 90% decline. Over the past two years, dealer corporate high yield inventory has averaged approximately $7 billion. Meanwhile, the asset class has grown from $600 billion in 2008 to $1.3 trillion today.

FIGURE 4



SOURCES: FEDERAL RESERVE; J.P. MORGAN; HIGHLAND ASSOCIATES

The broad adoption of ETFs has also caused a change in the market landscape. With dealers holding less cash bonds, investors have utilized ETFs to gain asset class exposure. In 2008, high yield ETF assets under management were $2 billion. Today there are over $38 billion in passive high yield ETFs, which comprise 3% of total high yield assets. The two largest ETFs, the HYG and JNK encompass $24 billion of the passive ETFs. The average daily volume for the HYG and JNK is $1.4 billion and $0.5 billion, respectively. According to FINRA TRACE, average daily volume for high yield corporate bonds has averaged $11 billion over the last three years. This means that even though high yield ETFs comprise a small amount of the total industry, they are responsible for a larger amount of the trading volume. This is important because ETFs buy and sell bonds based on predetermined rules rather than using an element of human investment decision. In addition, according to Western Asset Management, less than 8% of high yield issuers account for 50% of the trading volume. The result is that trading in the high yield market is very concentrated.

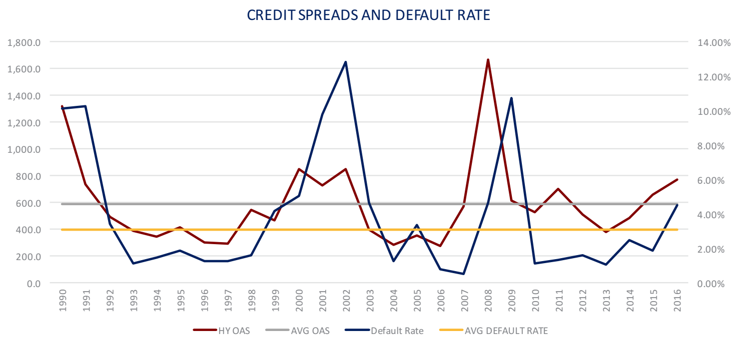
By our calculations, if all of the BBB energy bonds were downgraded to junk status, then the energy, metals, and mining exposure would increase by a multiple of 2-3 times.

CORPORATE DEFAULTS

The overwhelming majority of high yield bonds were initially rated by the credit rating agencies with a rating of BB or lower. However, a bond can also become a junk bond by being downgraded from BBB, also known as a "fallen angel". If we were to experience a wave of downgrades in the energy sector, passive ETFs would be forced by rule to buy many of these bonds. By our calculations, if all of the BBB energy bonds were downgraded to junk status, then the energy, metals, and mining exposure would increase by a multiple of 2-3 times. With energy prices likely to remain low through 2016, earnings deteriorating and rating agencies placing many of these bonds on credit review, it is not that farfetched of a scenario for us to see continued stress in these sectors. Consequently when there is minimal desire from investors to own high yield bonds, these downgraded bonds will increase the size of the market and exposure to energy.

In addition, we are beginning to see some of these energy and mining names default. Some of these companies hedged their oil and natural gas exposure when prices initially fell, but those hedges are rolling off and prices have not recovered. This January saw its third consecutive month of greater than $5 billion in defaults. This supports Deloitte's research that nearly 35% of publicly-traded oil and gas exploration and production companies globally are at high risk of bankruptcy.

FIGURE 5



SOURCES: BARCLAYS CAPITAL; DR. EDWARD ALTMAN; J.P. MORGAN; HIGHLAND ASSOCIATES

In 2001-2002, high yield telecommunication bonds experienced a 45% cumulative default rate and recovery rates averaged 25 cents on the dollar. Once energy companies begin defaulting and getting downgraded, we expect more downward pressure on high yield bonds.

For all of their faults, markets historically have done a good job of forecasting default rates within high yield bonds. Today, the market is forecasting a 4-5% default rate (see Figure 5). In addition, although high yield bond recoveries have historically averaged 40 cents on the dollar after defaults, the recoveries are likely to be lower this time. This is because when you get a sector that is defaulting in larger numbers, you are more likely to experience much lower recoveries. In 2001-2002, high yield telecommunication bonds experienced a 45% cumulative default rate and recovery rates averaged 25 cents on the dollar. Once energy companies begin defaulting and getting downgraded, we expect more downward pressure on high yield bonds.

When there is selling pressure and bond dealers cannot step in to provide liquidity, distressed hedge fund investors become the liquidity providers. However, this liquidity comes at a much higher price. When mutual funds need to sell bonds to meet redemptions and no one is there to purchase, then opportunistic hedge fund managers provide liquidity at deep discounts. The mutual funds have no choice but to accept the discounted prices, giving the hedge fund managers very attractive returns. The moral of this story is that current market prices don't always translate into the price you receive when you need to sell. Liquidity is a concept, and those that provide it reap the rewards. Those that need it pay the price, often times at a deep discount.

HIGHLAND'S VIEWPOINT

On the surface, prices for high yield bonds look attractive when trading at yields of approximately 10%. However, due to the structural changes in market liquidity and the expectation of more downgrades in the most stressed sectors, we expect high yield bonds to overshoot their fair value. In addition, with banks tightening lending standards and credit spreads widening, we believe this could cause an even higher wave of defaults than the market is expecting.

Due to the unintended consequences of central bank policy, the size of the high yield market has grown, drawing in additional buyers not generally acclimated to the higher risks. We believe that increased frequency of downgrades, defaults, and bankruptcies will ultimately squeeze out the investors that only came to the market for the extra yield. Until this capitulation occurs, we are holding off adding investments in long-only high yield bonds. For those willing to allocate to distressed hedge funds, providing liquidity has its advantages and the best laid plans of central banks are creating ripe opportunities.

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