

Don't Step on the Cracks

A. A. Milne's poem Lines and Squares turns a familiar childhood game into something rather more entertaining. Walking along a London street, the challenge is to stay safely within the paving squares and avoid the lines. Step on one and, in Milne's imagination at least, there are bears waiting at the corners to get you.

Investors might recognise the feeling.

A few weeks ago, one of the trust companies we work with asked us to take a closer look at the high-yield bond exposure within some of their clients' portfolios. They were becoming uncomfortable with what they were seeing at the lower-quality end of the credit market.

It was a sensible question then. After the past few weeks, it looks rather more prescient.

Because there are bears around today. In market language, of course, the bears are those expecting prices to fall, and recently they have found plenty to interest them at the weaker end of the credit

market.

Their question also prompted a useful exercise. Looking beneath the broad “high yield” label reinforced just how different the risks can be from one part of the credit market to another.

Cracks at the edges

There has been a sharp sell-off at the lowest-quality end of the US and European high-yield markets. Average yields across the CCC-rated bond market have risen to around 18% in the US and above 21% in Europe, although those averages are being pulled higher by some particularly distressed borrowers.

Those are uncomfortable numbers, but they need some context.

This is not a wholesale collapse in high yield. The problems have been concentrated among some of the weakest and most heavily indebted borrowers, while better-quality high-yield companies have proved considerably more resilient.

That distinction is important. A crack in one part of the pavement doesn't necessarily mean the whole pavement is collapsing.

What is a high-yield bond?

A bond is essentially a loan made by an investor to a company or government. In return, the borrower normally pays interest and promises to repay the money at an agreed date.

Independent credit-rating agencies assess how likely borrowers are to meet those obligations. Bonds with stronger ratings are described as **investment grade.** Those rated below BBB- by S&P and Fitch or Baa3 by Moody's are generally described as **high yield.**

There is a wide range of risk even within high yield. A BB-rated bond sits just below investment grade, while a CCC-rated borrower is considered substantially more vulnerable. Investors therefore normally demand a higher rate of interest as the perceived risk of not being repaid increases.

The important question is whether the additional return adequately compensates investors for the additional risk.

The refinancing problem

One reason we are watching the weaker end of the market carefully is that higher interest rates don't necessarily hurt every borrower immediately.

A company that borrowed several years ago at a low fixed rate can continue paying that rate until its debt matures. The problem comes when it has to refinance.

A company comfortably paying 5% interest can find the economics look very different if replacing that debt suddenly costs 10%, 15% or more. For a highly indebted business, the maths can change remarkably quickly.

And some of the weakest borrowers are approaching that test. Around 40% of US CCC-rated high-yield bonds mature over the three years to September 2029. In Europe, the figure is approximately 55%.

That doesn't mean those companies will default. Some will refinance successfully, improve their finances, or repay or restructure their debt. But markets are becoming much more discriminating between companies that can comfortably live with today's cost of money and those that cannot.

That, in our view, is healthy. **Risk should have a price.**

High yield isn't one market

There is another reason to be careful about drawing sweeping conclusions from the recent headlines.

While stress has become increasingly visible among some of the weakest developed-market corporate borrowers, other areas of higher-yielding credit have continued to perform well.

Emerging-market debt is a good example.

Within our portfolios we have exposure to emerging-market bonds through specialist and diversified bond funds. One such holding, the Morgan Stanley Emerging Markets Debt Fund, has performed strongly this year. Around two-thirds of the underlying portfolio is invested in emerging-market government bonds rather than companies, illustrating how different the risks behind apparently similar yields can be.

Morgan Stanley remains constructive on emerging-market debt, pointing to attractive yields, resilient income and improving fundamentals in selected countries, while stressing the importance of distinguishing between individual countries and borrowers.

That distinction matters.

“High yield” covers a huge range of countries, companies, industries and financial circumstances. Lending to an emerging-market government can involve very different risks from lending to a heavily indebted developed-market company struggling to refinance itself.

Both may offer an attractive yield. The risks behind that yield may be entirely different.

The label tells you surprisingly little. What sits underneath it matters far more.

When a high yield is trying to tell you something

At the more extreme end, the search for income can lead investors towards investments that should not be confused with the conventional high-yield market.

UK mini-bonds are a good example. These typically involve lending directly to an individual company in return for an attractive fixed rate of interest. They can be difficult to sell and have sometimes been promoted using reassuring terms such as “asset-backed” or “property-backed”.

A number have subsequently failed, and the FCA has heavily restricted the promotion of speculative mini-bonds to ordinary retail investors.

They are quite different from the diversified bond funds we use within portfolios, but they illustrate an important point.

A high yield is usually high for a reason.

The investor's job is to understand what that reason is.

Look beneath the surface

The same principle applies across credit markets.

The headline yield is only one part of the story. The financial strength of the borrower matters, as does how much debt it carries, when that debt needs refinancing and how likely it is to repay investors.

So while the recent cracks in lower-quality credit deserve attention, we don't believe they are a reason to abandon higher-yielding investments altogether.

Markets reward investors for accepting risk. Avoiding risk altogether also means giving up the potential return that comes with it. The objective is not to eliminate every risk from a portfolio, but to understand those risks, diversify appropriately and decide whether investors are being sufficiently rewarded for taking them.

Within diversified portfolios, exposure to higher-yielding credit can take many forms and will change as underlying fund managers respond to market conditions. What matters is not simply the label, but the quality of the underlying borrowers, the diversification of those exposures and the judgement of the managers selecting them.

A diversified fund holding emerging-market government and corporate bonds can behave very differently from a portfolio concentrated in the weakest CCC-rated companies. Both are very different from lending directly to a single company through a mini-bond. Each may offer a high yield, but the risks underneath that yield are not the same.

Perhaps Milne had it right after all. You don't necessarily need to stop walking just because there are bears around. You simply need to pay rather more attention to where you're putting your feet.

Not every crack becomes a fault line. But when cracks start appearing, it pays to know where you're standing.

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