A value approach for corporate bonds offers a higher risk premium for less actual risk

By Klaus Blaabjerg, Head of Value Bonds team, Sparinvest

As a value investor Sparinvest has built an investment process to capture opportunities in the corporate bond market by value screening. This means:

- Focus on financial ratios, not ratings, (small cap, net debt/equity, interest cover, price/book),
- Company analysis (financial reports, management style, competition),
- Bond analysis (covenants, options, relative value).

Portfolios are thus constructed through a 100% bottom-up process with focus on value. This results in products offering a solid return at low risk.

There can be little doubt that the financial world is awash with fear. Why else would investors settle for a paltry yield of 1.7% on US sovereigns – or even negative yields in German Bunds – when the world is still expected to produce nominal growth of 5% in 2012? Volatility is high and the investment cycle short. In such an environment, investors are particularly inclined to opt for so-called 'safety' even if in reality it results in diminishing purchasing power. But are German and U.S. government bonds really a logical choice? Germany is becoming ever more embroiled in the Euro crisis and U.S. government bonds do not reflect the actual financial risks present in that country. These loans are priced for perfection, while the underlying conditions are far from perfect. So the loans of these countries are less gilt-edged than people think. Norway and Australia, on the other hand, are in a much better financial position, meaning that their sovereigns offer a lower risk of default.

Are corporate bonds 'safer' than sovereigns?

It's a fundamental principle of bond investment that it only makes sense to lend money to entities – be they governments or companies – that are in a strong position to pay you back with interest. For this reason investors would do well to consider the attractions of corporate bonds issued by relatively undervalued but financially solid companies.

We are currently in a low growth environment, with deleveraging and credit recuperation. Banks are raising their buffers so that companies are forced to go to the capital market for financing through corporate bonds. Many companies have deleveraged and are in good shape, so that their corporate bonds often carry a lower level of risk than sovereign bonds (which also actually carry political risk). Also, the yield of corporate bonds is significantly higher, especially when investing in the credits of solid smaller and medium-sized enterprises, with a coupon far above average. This premium can be secured on the basis of stringent analysis. Value premiums are lower in the bond world than in equity investment, but in this environment, you are more certain that you will collect those premiums. That is also why low debt ratios are key. Companies with low debt can afford to pay the coupon on their bonds. Set against that, share prices can eventually double in price, unlike bonds.

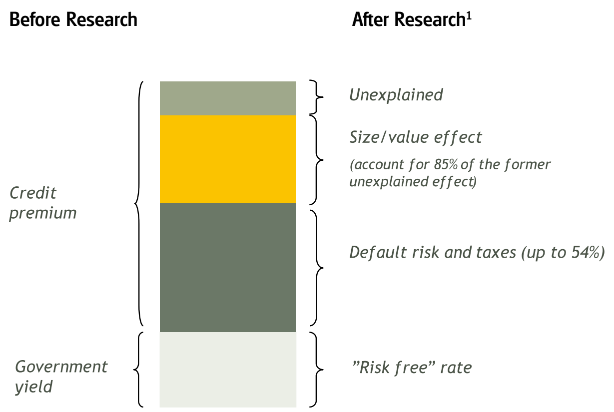
On average, the risk premium for high yield corporate credit is relatively high at around 8% whereas the default

risk is low (Sparinvest estimates it at about 2.5%). The key to securing a high yield with lower risk of default is to select loans through the rigorous process known as the value approach.

How does a value approach to fixed income boost returns?

Many smaller and undervalued companies with strong balance sheets, excellent profitability and a low default risk are still forced to pay higher interest on loans simply because they are small or out of favour. These bonds yield a risk premium that matures – either by a takeover of the company, or when the bonds reach the end of their loan period. This is underpinned by researchers Edwin Elton and Martin Gruber[1]. They concluded that only half of the corporate premium versus sovereign bonds is explained by default risk and tax. The other half has to do with the size of the company being financed and value effects. It is actually an unjust form of discrimination: high yield value companies are characterized by the fact that they are reluctant to take more debt: they want to maintain their cash flow capabilities. In fact, high yield value companies are more conservatively financed than their 'investment grade' counterparts. Many investment grade companies are currently performing share buybacks to support their stock prices and have a worse track record of debt repayment.

The Elton/Gruber breakdown of Yield to Maturity



Source: Elton, Gruber et al (2001)

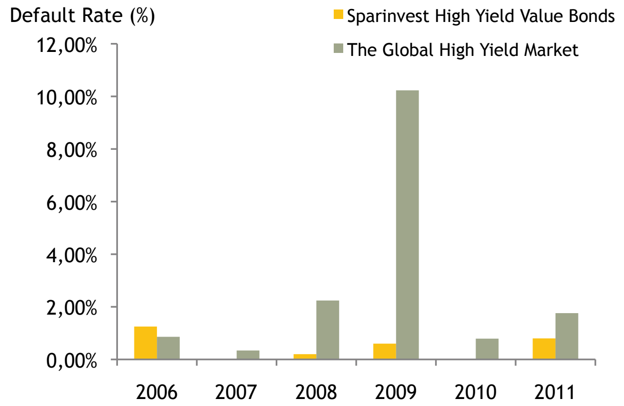
[1] "Using the Fama-French factors, as much as 85% of the credit spread is not accounted for by taxes and expected default, can be explained as a reward for bearing systematic risk." Journal of Finance, 2001

The value approach aims to optimize investors' return by finding mispricing opportunities within the substantial credit premium we see today. Forensic company research, with a focus on financial ratios and not ratings, is essential to find attractive fixed income investment propositions. Smaller companies pay a higher premium because they are smaller. Value companies pay a higher premium because they are 'out of fashion'. Companies from emerging markets pay a higher premium because of their 'riskier' geographic location. These factors form a value scenario, whereby individual companies with a strong balance sheet and a visibly good record of debt servicing still have to pay higher premiums in order to be financed by the market. Thus credit markets are not efficient and the value bonds approach is used to exploit these inefficiencies.

How does Sparinvest use company analysis to capture return potential?

Sparinvest has several filters in its value bonds analysis process. First it screens the total universe with a focus on financial value ratios, such as small cap, low net debt to equity ratio, strong interest coverage, low price to book. Choosing companies with attractive key ratios yields outperformance, alpha. For example: UPM-Kymmene has a net debt to equity ratio of 57%, while for high yield companies in general, a rate above 300% is not unusual. The estimated fair value of the assets of that business is equal to the entire debt of the company, thereby reducing the risk of losing the principal amount to nil. This company can in fact be considered a safer investment than most government bonds! For Sparinvest, these kinds of business loans are a target. The next layer of analysis uses company financial reports, looking for cash flow to minimize the chance of bankruptcy; management style is assessed, and a peer group analysis performed. Importantly, a governance analysis checks that loan covenants are waterproof. Sparinvest also looks for good relative value, loan to value and a low probability for default. Sparinvest prefers to make its own assessments than to rely on agency ratings. Agencies often discriminate against small and mid-cap companies because they do not know them and do not pay attention to them. That is why such companies have to pay a higher risk premium. For Sparinvest, only when all lights are green on an investment will it take place.

Focusing on low Net Debt to Equity works – defaults are lower for Sparinvest High Yield Value Bonds



Value bonds risk management

Sparinvest's risk management focuses on fundamental economic ratios versus the price of the bond. Risk management must be based on economic risk budget and not on VAR, value at risk, or tracking error. These are measures that assume efficient markets and not the behavior of market subjects based on greed and fear. Using tracking error as a measure runs the risk of matching the portfolio with an index composed of companies that have high debt levels. Using VAR as a measure runs the risk of 'buying high and selling low'. Value investors buy when others are afraid to buy, despite the profit potential. Value investments characteristically underperform going into recession, but outperform coming out of recession. Over the entire economic cycle, the value investment approach is clearly the winning strategy. Smaller companies usually have a cyclical nature. This means investors need a long term view to sit through underperformance. It also means that fund managers have to be fully convinced of their selections and must be able to bear 'career risk'. That risk could be mitigated through derivatives.

Fund Profile: Sparinvest High Yield Value Bonds

Over the past three years, High Yield Value Bonds made a total return of +92% against +75% for the BofA Merrill Lynch High Yield TR. This fund invests in strong listed companies. The default rate on average is only 1%, compared to 2.75% in the global high yield market. The fund is currently extremely cheap with a yield to maturity of 14.3% versus 8.6% for the index. The net debt to equity of the fund is 82% (excluding financials), versus 321% for the index. The duration of the fund is 3.75 versus 4 for the index. Although a relatively short duration mitigates risk, duration is less important to Sparinvest than profit development and risk perspective in a company. The rating of the index is B+ versus BB- for the fund. High Yield Value Bonds deviates significantly from its benchmark in that it does not have any US credits in portfolio, but it does have about 20% in Norway, besides holdings in the UK, Sweden, France and The Netherlands.

Fund Profile: Sparinvest Emerging Markets Corporate Value Bonds

Sparinvest Emerging Markets Corporate Value Bonds was launched in September 2010 and has delivered a return of over 12% since launch to end July 2012. The fund deviates significantly from its benchmark the JP Morgan Corporate Bond index, with current holdings of 12% in Brazil, 9% in China, 9% in Mexico, 8% in Russia and 5% each in Norway and in Indonesia.

The Sparinvest High Yield Value Bonds strategy is about EUR 1 bn. in size. The funds following the strategy offer daily trading, based on net asset value. The funds are quoted in euro.