

A value approach to corporate bonds can offer high returns with low risk

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Sparinvest's High Yield Value Bonds was rated AAA- by the German ratings agency, TELOS. One of the main reasons for this rating was the fund's excellent performance. Why has the fund performed so well despite the current difficult market situation? How important are the recent political developments in that respect?

The short answer is very low default activity in the fund. This has always been the case. If you look at 2009, which was the worst year in terms of growth and defaults, the fund experienced around 2% defaults compared to 10% for the market. So our focus on low leverage and ample asset coverage has paid off.

Even though 'normal' corporate bonds are less lucrative in terms of yield – don't high yield bonds carry too much risk? What exactly are your measures to minimize these risks for the investor?

Looking at default activity for the market in general and credit metrics for the 'average' of high yield companies I disagree – i.e. I don't believe high yield bonds carry too much risk. In terms of risk and reward the market still offers value, because current premiums are higher than expected losses. BUT of course I believe you can do better than the average market ! – By looking at companies with low leverage and companies that have fallen out of favour or are not so 'big' in indices, you can create portfolios with higher yields AND lower default risk. This is what our fund is all about. Of course we can only do this because there are so many index tracking funds in the market.

What are the advantages of investing in smaller, under-rated companies compared to companies with a good rating?

Here you have to be careful not to mix things up. Small companies can actually have very strong credit quality in terms of interest coverage and leverage, but are often rated lower than larger companies (ceteris paribus) because rating agencies have a preference

for larger companies. So this rating induced tilt against small companies creates a very explicit small cap premium in credit markets. The REAL disadvantage with small companies is the lower liquidity in the market if you want to trade their bonds. This is something you have to consider, when you construct the portfolio. This is definitely something we have in our minds !

How (and where) do you and your team find the companies for the fund? How do you make sure that they are substantially valuable, despite their bad ratings? It would be nice if you could refer to the 'Debt/Equity-Clock' e.g. which phase is best to place an investment?

We find the companies through screenings. We look for companies that have low Net-Debt-to-Equity and are cheap on Price-to-Book. Low Net-Debt-to-Equity is about avoiding loss of principal and low Price-to-Book is about exposing the fund to 'positive optionality' – i.e. many bonds in the high yield market have change of control options. The change of control option is an embedded PUT OPTION into the high yield bond giving holders of the bonds the right to sell at a price of 101 in case of a takeover of the company. So when you look at companies that are cheap you basically look at companies with a higher probability of a takeover event, this is then interesting if you can invest in bonds far below 101, because returns can then become 'Equity like'. BUT of course these 'Equity like' returns come with lower risk than ordinary equities. Credit investments are best when leverage is falling, because this is when the risk of defaults is decreasing. The worst credit investments are into companies that are gearing up (increasing debt) to buy back their own shares or pay out large dividends – here you see a transfer of wealth from credit investors to equity investors.

How do criteria like SRI or ethical aspects influence your choice of companies?

SRI and/or Ethical focus is not new for us. For us this has always been in our minds. The reason is that we

don't want to expose investors to large 'tail risk' – like litigation risk or the risk of large lawsuits. This is why we never invested in the Tobacco industry for example. This is also why we like oil exposure in the North Sea compared to the Gulf of Mexico. In the North Sea environmental considerations have always had a bigger focus.

Which economic branches offer preferred picks for the High Yield Value Bonds? Why?

If we look back at our own history we have always had high exposure to the Energy Sector. Here you get what we would call 'hard assets' – oil fields or equipment, something that could be sold if needed. Otherwise, we have no preferred sectors over time but go really bottom up into companies that have low leverage and improving fundamentals from a credit perspective.

