Understanding Short Duration for the Long Run

Disruptive Forces in Investing **April 12, 2022**

Anu Rajakumar: Investors today are grappling with asset allocation decision in the face of rising rates, stubborn inflation, and slowing growth. With stock and bond correlations appearing to turn positive, the effectiveness of long duration investment grade government bonds as a natural hedge for riskier assets is likely to fade. So, where are the opportunities in the broad global bond market? So today, we'll do a deep dive on the short duration high yield market. Explaining what it is, and the characteristics that make it well suited for this macroenvironment. My name is Anu Rajakumar. Joining me today from the Neuberger Berman Chicago officer are Chris Kocinski and Joe Lind, Senior Portfolio Managers and Co-Heads of our U.S. High Yield platform at Neuberger Berman. Gentlemen, thank you for joining me today.

Chris Kocinski: Thank you. Great to be here.

Joe Lind: Thanks for having us.

Anu: Chris, let's start with a primer. Give us an overview of the topic of the day, i.e., what is high yield? And what does it mean to be short duration high yield?

Chris: So we think of the high yield market as the steppingstone between fixed income and equities, where investments in high yield bonds are typically not secured by collateral. But they're also not exposed to the full fluctuation every day on the enterprise value of a business, like a common equity would be.

If you think of the market in terms of debt to value, and where you're lending to a business at, the high yield market is around 50 percent debt to value. So it carries more credit risk than investment grade, for example, which would typically be between 20 and 30 percent. But you do have some cushion in terms of the enterprise value of a business to help in terms of income generation before you would experience any loses. The way asset owners think about high yield as an asset class is as an income enhancement in their broader portfolios. The key drivers that are tracked by us and other market participants are default rates, which are highly correlated to GDP growth, particularly in the U.S., and interest rate movements, as well as idiosyncratic factors related to specific industries or business models. And we think highly correlated to economic growth trends, specifically in the U.S. and pretty well insulated right now in terms of exposure to events that are happening around the world.

Joe: One thing I'd add is that high yield is a little different as an asset class, because the terms of every bond is unique. Even within a single company, bonds can have really different security characteristics and covenants. The biggest question we always ask ourselves is will you get paid back? And so that's really the credit underwriting process that our research team does. And given that diversity of characteristics, especially in short duration where the bonds are either refinanced, mature and are repaid, or the company goes default. That type of binary outcome really lends itself to security selection and active management.

Anu: Terrific. I like that. Bring it down to the layman's terms. "Will you get paid back?" is the key question. Thank you very much for the background. Just to put all this into context, so much has happened in the last 12 to 18 months. The pandemic, inflation pressures, and most recently the Russia/Ukraine crisis. Tell us about how the high yield markets have reaction to some of those events.

Joe: Certainly there was a big reaction in March of 2020, where markets around the world had significant drawdowns. Mainly because prices there tend to remain higher for longer. And so, as fixed income and really asset allocators looked for things that they could sell, high yield as well as short duration high yield, did drawdown quite a lot. I think that's something that we do hear from investors as a criticism. However, would point out that it also tends to come back very quickly. If you think of the question are you going to get paid back, that's a much easier question to answer with less information. And so, we tend to see those drawdowns are shorter in timeframe. And in periods like now where the information, while there certainly is a lot of geopolitical information, a lot of macro information, coming through at a pace where investors can digest.

Last year, we did a lot of work just on whether inflation was transitory, and we began to see that some of it certainly was structural. Specifically around labor. And we're really seeing that flow through. As well as the news of this year. Just the commodity pressure that we're facing I think are starting to affect company profits. We're seeing some companies have declines in their profitability versus last year where they were saying inflation was a good thing because it expanded margins.

We're not surprised by that. That was something we have been able to pivot away from some of those companies where we really worry about their ability to match their input costs, and the ability for them to pass on price. Something that would be right down the middle of that would be food and consumer product companies, as well as companies that are exposed to lower income consumers, where the increase of energy costs really start to affect their balance sheets. The good news in terms of short duration is it gets back to that main question of can these companies refinance their debt? And so, if our answer is still yes, and if they can still afford to pay higher interest rates then that still provides attractive investment opportunities because there is a natural pull to par, as the bonds get closer and closer.

Chris: And if you think about just going back over the last 24 months, have been pretty volatile conditions in all markets, including in the high yield market. A few key takeaways for high yield. Dealing with the COVID pandemic defaults peaked at about half of where they had been in prior recessions. So, the market was very effective at raising capital to help businesses bridge through the COVID crisis. And the reason for that, I think investors were asking themselves are these problems temporary, or are they permanent? And they were willing to invest in companies to help them bridge through their liquidity needs for a business that they didn't view as permanently impaired. Thinking in the leisure space would be a good example. Market took a view that people will eventually return to travel, even though it's not happening right now. So we feel confident providing additional liquidity to that sector. And that's different than a business that might be facing a secular challenge, or just a very clearly over-levered balance sheet where it would be necessary to go through a bankruptcy process at that time. Defaults at about half of prior peaks is one takeaway from the COVID cycle. I think as it relates to what happening in Russia, Ukraine today, it's important to keep in mind the revenue drivers for the US high yield short duration market, specifically about 80 percent of revenue in that market is generated in the US. So it's a very U.S. economy-centric market that doesn't have much in terms of direct exposures to those geopolitical events. And the exposure is more centered around what are the impacts of that on the global economy.

Anu: Great. Thank you. Chris, you just mentioned defaults at half of prior peaks. So, clearly the high-yield market was quite supported through these volatile conditions. So it sounds like maybe the volatility didn't necessarily change the risk profile of the high yield market through these recent issues. But maybe you can answer what conditions would trigger that risk profile to change, as well as the reliability of the yield that the market's offering?

Chris: The reality today is the high yield market is the highest quality that it was been in its history. If you look at the published credit ratings, it's about 90 percent Double B and Single B, and only 10 percent Triple C. The mix of Double-B bonds is at its highest point in history. In part because there was a good cohort of names that were downgraded from Triple B into high yield at the onset of the COVID crisis. And now they're in the process of repairing balance sheet, and we hope ultimately moving back into the investment grade credit market. So, we're starting from a pretty healthy perspective from a credit quality standpoint. I think that's an important thing to note about the current volatility that we're seeing in markets today. Second, the main contributing sector to defaults in high yield in the past has been energy. And what we're seeing play out in the geopolitical landscape today is causing increased commodity prices. And that dynamic is helpful to their balance sheets, as opposed to being something that we think would cause a default cycle in energy. It's quite the opposite at the moment. So we don't expect the energy sector to be as much of a contributor to defaults in the next couple of years, as it has been in the past. And what I think in terms of what could trigger a change to the risk profile, the most important one that we always like to highlight is the self-inflicted damage. That would be leveraging activities. And I think it's a pretty stark contrast to when you think of high yield leading up to the 2008-2009 financial crisis, there was a significant amount of very large, highly levered LBOs that came into the market. That hasn't been coming to high yield now for several years. First, there haven't been as many mega LBOs. And second, a lot of that debt has been issued in leveraged loans or private credit, and less has been coming into high yields. So, it's really another factor where the market is cleaner than it has been at the past from a credit quality standpoint. And when you go through a geopolitical issue, which now is becoming an inflation issue, and what does that mean for growth. And you think about the market volatility that we've had year to date, it's nice to be starting from a point that is of the better credit quality than we've seen over time in the market.

Joe: I think another way to think about short duration and the risks that you mentioned, is to think of it as a vintage. What an investor might get today investing is that they'll pay about par. That's where the index is trading, 100 cents to the dollar. And the yield is about five and a quarter percent. Over the next three years, all of those bonds will mature, get refinanced, or default. And our internal projections for defaults in the next couple of years are less than 2 percent. And so when we look at the yield and spread of the short duration market versus the full market, it ranges. You get about 70 to 90 percent of the full market yield. And right now, you're getting 89 percent. So, you're in that top 5 percent of history on a relative yield versus the overall market, which is one of the reasons why we're having this podcast.

Anu: Yeah, absolutely. A very attractive value proposition at the moment. Thank you. Just transitioning a little bit: ESG is a huge trend that we like to speak about on this podcast. Would love to hear briefly how you address ESG integration within your own investment process?

Chris: Well, if we start with the question that Joe raised of, “Are you going to get paid back or not?”, and deeply understanding the ESG risk profile of an issuer, we think is core to how you should look at high yield investments. So just starting from an investing standpoint, we think it’s critical to understand those drivers and systematically rate those, and consider them when we make investment decisions. I think one of the factors that asset owners and market participants underestimate is the access that fixed income investors have to management teams. There’s an assumption that because fixed income doesn’t have proxy voting that you have less ability to influence management through engagement. And we found the opposite to be true in the high yield market, where we have access to CFOs and CEOs. And we're able to engage with them on the ESG topics that are material to their business, and material to our investment. That helps everyone involved. It helps out investors through lower default experience. It helps the businesses we invest in by encouraging them to improve in certain areas over time. So there’s an investment integration component to ESG that we take very seriously on our team and have a robust process around. And then there’s engaging with companies, which we're very proud of the platform that we have Neuberger to do that. But to be honest, I think we could probably have an entire podcast on that topic. I’ll leave it there as a brief intro for the moment.

Anu: Terrific. We would be glad to have you back for a deep dive on your engagement. But actually just quickly on that, I would love it if you could share an example of an engagement with a company-owned issuer on those ESG practices just to give a little bit of life to what you just said.

Joe: Certainly. So, one recent example of an engagement we had with a North American natural gas producer, which is, you know, certainly a company that is clearly concerned with the E in ESG. We've engaged with this issuer many times. They recently brought a problem to use to try and get our advice. We consider them to be one of the most efficient producers of natural gas in North America. And the state that they operate in agrees, and asked them to take over some older, highly polluted wells. Now, we thought that was a good idea. The management team also thought that was a good idea. However, the problem is that it would increase their year-over-year greenhouse gas emissions. For third-party data reporting on greenhouse gases, it would make them look that they're doing worse, and they're becoming less efficient. So we engaged with the management team, and reached out to colleagues across Neuberger Berman, to really try and dig into how we can benchmark their scoring, and how we can show that they're still making progress on environmental concerns, while at the same time working with the community to try and reduce pollution in the state that they operate in.

Anu: Yeah Joe, I want to just underscore to our listeners the importance of these engagement efforts. The example that you’ve shared is great to hear. We believe at the firm that when you have authentic and thoughtful engagement embedded in the portfolio management teams, the outcomes are long-term value creation for our clients. I think that’s really important for our clients to hear. Well, thank you both. This has been a terrific episode so far. We're going to begin to wrap up. And I’d love to get your outlook going forward. Of course this is a complex environment that we're going into. As I’ve said before, high inflation, rising rates, potentially economic slowdown. We've even seen the yield curve invert recently. What are your thoughts going forward?

Chris: Well, as you note, there are a number of factors that have changed over the past several months, in terms of concerns around inflation being higher and more persistent than what was previously anticipated. We have disruption in commodity markets and other factors that you mention in your question.

Ultimately, what we think what will win out is that most companies in the short duration high yield market will repay their debt and be able to access capital to refinance maturities. And we expect default rates to remain very low. And the credit fundamentals for this market are primarily driven by the U.S. economy, and we think their balance sheets are in good shape. So, when we think about the market, you're getting an income enhancement relative to alternatives in fixed income, without taking much in terms of duration exposure. It’s about a two-year duration, and lesser volatility based on history in terms of bond price movements when compared to longer duration instruments. Our view is that there is a place in asset allocations and portfolios for that type of income enhancement vehicle. But clearly, as you mention, there’s a number of factors we're going to have to keep stress testing and going through with our team. And we will continue to do that.

Joe: Yeah. We really get two points of pushback from investors on their concerns today. We hear a lot about concerns on interest rates, and we hear a lot about concerns on economic slowdown. Short duration certainly addresses the interest rate concerns, just by its very nature. And on the economic slowdown, I think as Chris mentioned earlier, we're just starting from such a robust position in terms of the quality of the high yield market. In the short duration market, the ability of companies to pay more if they need to refinance debt really provides a substantial cushion. We struggle to see how the outlook for economic slowdown really starts to get into that zone of insolvency that would be required to derail the thesis.

Anu: Great. Well, thanks very much. Now before I let the two of you go, I'm going to give you a bonus question just for fun. It is April right now. It is the beginning of spring. We've all been thawing from the long winter here up north, and especially in Chicago. So I'd love to know: what is your favorite place to go this time of year? Maybe Chris, starting off with you.

Chris: I would take the mountains in Tennessee would be my favorite place to go in the spring. It might get a little sloppy on the ground. But nice to take a hike and get some fresh air.

Anu: Lovely. Thank you very much. And Joe, what about yourself?

Joe: I met my wife in southern California. And at this time of year, we always have to go somewhere warmer than where we live. So, I'll choose southern California.

Anu: I think both of those sound like excellent options. Joe, Chris, thank you very much for joining me today. Very much appreciate your thoughts on this topic, especially as we continue to grapple with the ongoing risks of inflation and economic slowdown, and what that means for asset allocation. Always helpful to hear, and special thanks for sharing some of those ESG engagements as well. So thank you very much for joining us on the show today.

Chris: Thanks again for having us.

Joe: Thank you very much.

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