

PM Perspective

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High yield: an opportunity not to be missed?



Andrew Wells is Global Chief Investment Officer, for the Fixed Income and Investment Solutions Groups at Fidelity International.

Andrew joined FIL in 1996 as a Money Funds Trader in FIL's London office and soon became Portfolio Manager responsible for the Institutional Cash Fund. He transferred to the Hong Kong office in 2002, originally working as a Portfolio Manager running a wide spectrum of fixed income funds including cash, single currency, global, emerging market and high yield bonds. He became Chief Investment Officer, Asian Fixed Income for Fidelity in Hong Kong in 2005.

Andrew received a B.A. (Hons) from Kingston University. He also belongs to the Association of Corporate Treasurers (A.C.T.) and holds an Investment Management Certificate (I.M.C.).

AT A GLANCE

- Investors should use fundamentals and history as a guide to their decision making rather than price.
- Periods of market stress present opportunities for investors prepared to a longer-term view than myopic markets are currently taking.
- The opportunity to invest in high yield bonds at "distressed" levels provides patient investors with a strong platform for future return potential.

In the present environment, investors must let fundamentals be their guide, not prices.

Right now, valuations are again at odds with fundamentals and liquidity is the cause. Just as we saw in 2008/09, an historic opportunity to achieve very rewarding returns is on offer for investors prepared to take a longer-term view than myopic markets are currently taking.

One does not have to look back too far in recent history to see examples of severe market dislocation which presented excellent opportunities for investors. Last time around, it was September 2008 as the global financial crisis materialised and investors exited risk assets in large volume. With perfect hindsight, all investors would have taken advantage of the buying opportunity in high yield bonds in the first quarter of 2009.

Since then, we have learned much from the analysis of liquidity stress by looking at how "off-the-run" bonds trade versus their more liquid benchmark equivalents or how TIPS trade relative to nominal bonds, adjusting for inflation. Or, in high yield, how a "distressed" issue (where bonds trade at a spread of over 1000bps [10%] even though their business fundamentals may still be continuing as normal, showing no signs of the labeled "distress") can be very misleading when it translates to actual defaults.

The parallels with 2008/9 and now are obvious. Markets have become dislocated again due to continued concerns over global growth and sovereign stress. These worries, which remain centred on the US and Europe, continue to rock risk assets, drive liquidity down and liquidity premia up with high yield bonds the most clearly impacted category in the fixed income universe.

Two factors have predominantly impacted high yield assets recently. First, the downward revision of the economic outlook earlier this year reduced the potential for early sovereign debt reduction for some developed markets and consequently impacted banks particularly exposed to sovereign risk. Second, the fall in equity markets has prompted some profit taking on investments made in previous years in high yield bonds to compensate for current equity markets losses. These profit-taking flows are creating what we believe is a genuine opportunity in the high yield bond markets as the fundamentals of many of these companies remain healthy – a fact which is totally disconnected from excessively low valuations now available.

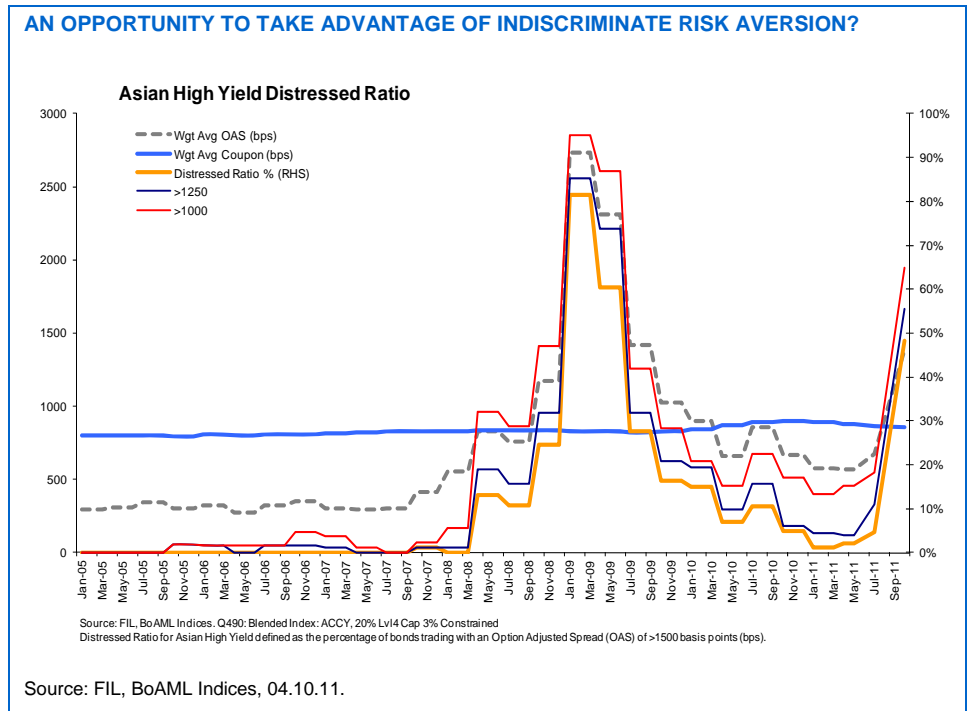
A quite similar dislocation between fundamentals and valuations in 2008 was driven by liquidity and saw investors suffer a painful total return of over negative 25% in that calendar year in some high yield categories. However, in 2009, when liquidity returned, investors saw their fortunes change, with total returns of almost 60% in European High Yield and almost 80% in Asia with a further 15-20% available in 2010.

It is possible that the economic recovery will be slow to emerge and even once established, it may be slow to develop and mature. This would not be a negative scenario for high yield assets as most companies have kept their cost bases under strict control. They continue to have access to banks lending even if terms become tighter and they have actively managed their own refinancing needs in the past two years to protect themselves from exactly this kind of volatility. These factors should contain the default rate at low levels for a prolonged period. Such a low growth scenario - but not a recession – is typically a sufficient condition for investors to get the benefit from investments in high yield bonds.

In the short term, investors may still face the risk of seeing the value of their investments fall as markets price in a heavy liquidity premium and valuations lose their connection with the fundamentals which are central to investors getting their money back plus some return for the risk taken. However, the total return of the asset class is now supported by a very strong income stream, with some of our high yield funds are currently yielding over 15%, which will go a long way to protecting total returns from this point.

Again, we do not see a significant pickup in troubled companies – just as we didn't see it in 2008 – and our analysts argue that most companies are in a better position than they were back then.

In conclusion, I believe the current dislocation in financial markets presents a rare opportunity for investors willing to take a view that what has happened before is happening again. This is a chance to buy into high yield bonds at “distressed” levels, which provide the potential for very attractive returns in the quarters ahead. For those investors already invested, we do not believe the market moves are warranted and would certainly not be selling at these levels. And for those investors looking for value, recent history does indeed appear to be repeating itself.



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