Finding positives in a negative-yield environment

By Frank Mullen, portfolio manager

You didn't have to be active in the fixed income markets to hear constant talk of negative-yielding debt in 2019. Even non-financial news sources realized the absurdity of paying someone for the "privilege" of lending them money and locking in a negative rate of return (if you held the investment to maturity). Bonds had negative yields in other years, but the craziness ramped up in 2019, with the total outstanding hitting a peak of US$17 trillion in the summer.[i]

It wasn't the amount of debt that surprised me, but the fact that it crept from government bond markets into investment-grade credit and finally into the high-yield market. Negative-yielding, high-yield debt sounds like the perfect oxymoron, but in 2019 several European high-yield issuers had debt trade at negative yields.

Every time you make an investment, you are making a conscious decision that you have found an investment superior to the other alternatives available to you. However, investors can find themselves doing some perverse things in a world where investment alternatives include negative-yielding investments. Every investment looks great when compared to a negative-yielding alternative, and that's the ultimate issue in the current investment environment. Traditional buyers of assets that are now negative yielding are forced to find other sources of income and, in today's connected world, that shift has driven down the yields while driving up the prices of many other asset classes.

The balance between risk and return

Analyzing the relative attractiveness of an investment is certainly a part of our investment process, but analyzing the risk that must be taken on to earn that return is just as important. We would never simply buy the highest-yielding debt we can find as it may also be the riskiest. Finding the right balance between risk and reward is crucial to any investment and we focus a tremendous amount of our time on this. We spend our days studying company financials, credit indentures and analyzing various parts of the capital structure to better understand the downside risk of every investment.

Buying something simply because its yield is better than zero could open up investors to a significant amount of risk, as the pleasing yield in the short term could come with consequences in the long term.

Investment-grade bonds

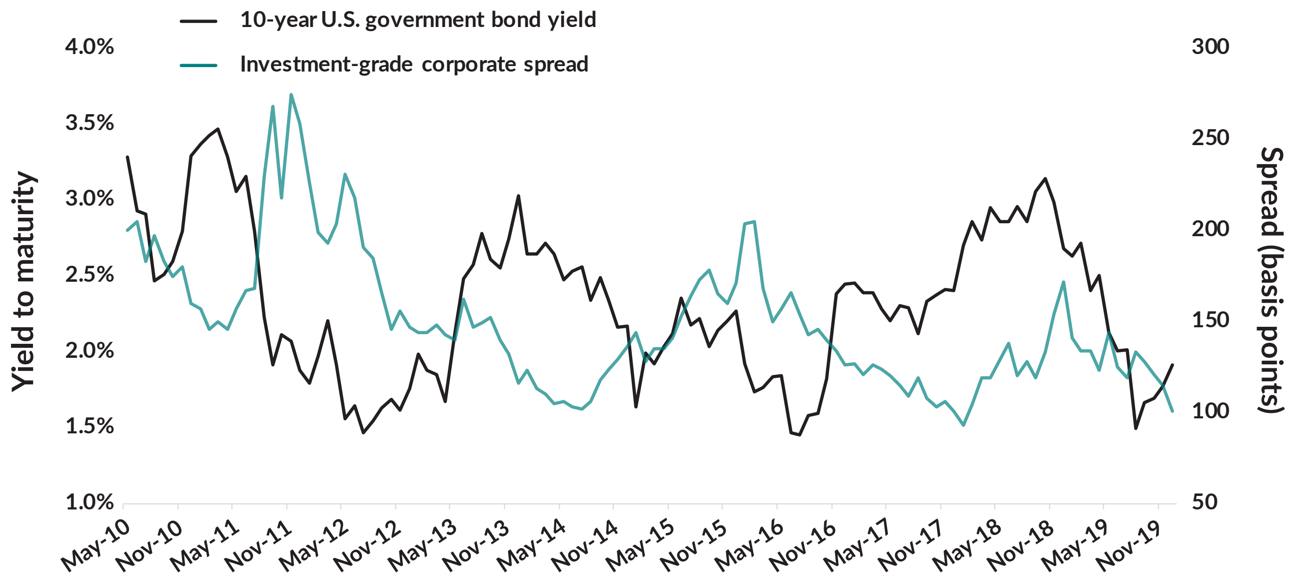
Investment-grade bonds had a great year in 2019. Their long duration benefited from both a decline in interest rates and spread tightening. These moves caused the yield on the U.S. investment-grade index to fall from 4.40% at the beginning of 2019 to just over 3% today.[ii] That 3% yield is certainly higher than the yield on government bonds in most developed markets and certainly better than negative, but investment-grade investors today are accepting a lower yield for an asset class that, in my opinion, still has a material amount of risk exposure.

The fundamentals of a business ultimately determine its ability to service and repay its debts. A closer look at corporate fundamentals for investment-grade issuers shows that the amount of leverage companies have undertaken is at a historically elevated level and that their revenue and earnings before interest, tax depreciation and amortization (EBITDA) growth has lagged the overall U.S. economy.[iii]

At the same time, the investment-grade index is now more sensitive to changes in interest rates and credit spreads than it has been in the past 20 years. The current low yield and long duration of these bonds means that their price changes resulting from a movement in rates and credit spreads are larger than in the past. The higher sensitivity can help if credit spreads continue to tighten or if interest rates go lower, but this hasn't happened many times before and the chart below shows that both yields and spreads are at or near the lows of the last decade. Any reversion upwards would have severe negative consequences on the returns of investment-grade bonds going forward.

Government yields and corporate spreads

May 31, 2010 to Dec. 31, 2019



Source: Bloomberg LP. As at December 31, 2019. Bloomberg Barclays USD Liquid Investment Grade Corporate Average OAS Index and US Generic Government 10 Year Yield used in the above chart. May 31, 2010 is the earliest available data for the Bloomberg Barclays USD Liquid Investment Grade Corporate Average OAS Index.

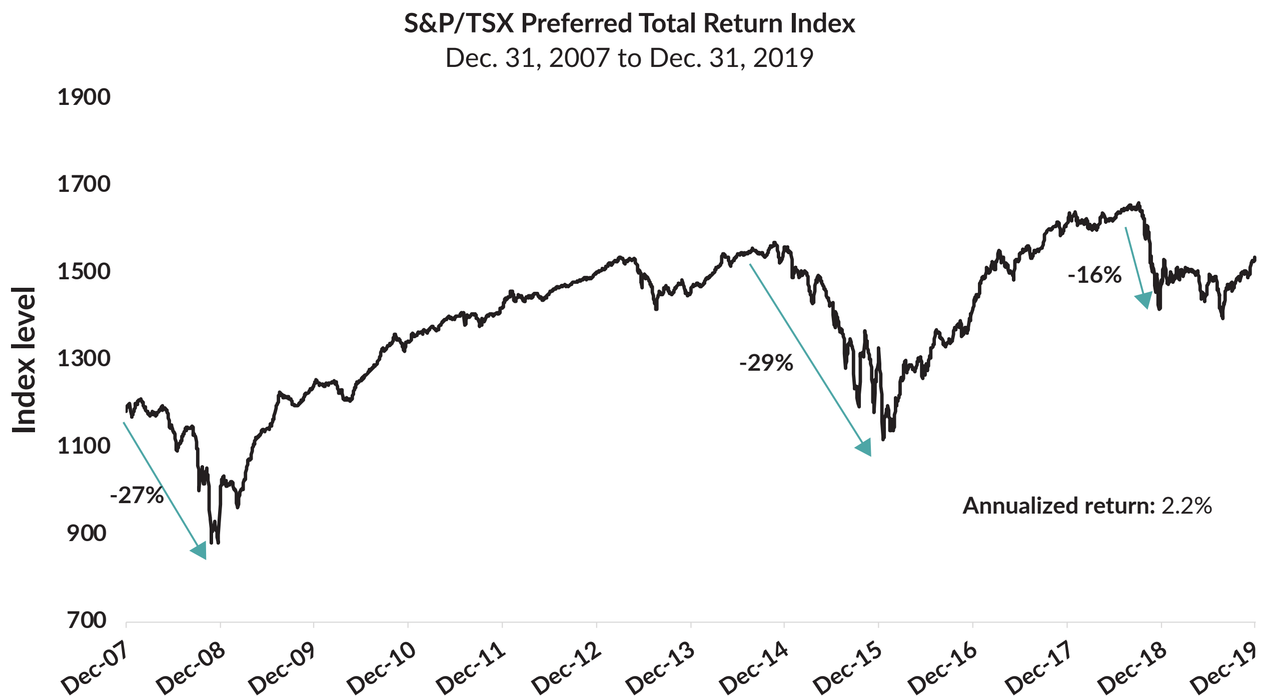
The amount of outstanding debt rated BBB (i.e., the lowest-rated investment-grade debt) increased by 217% since 2009 and now makes up 50% of the investment-grade index.[iv] Many of these companies are at risk of being downgraded to high-yield status if we have an economic slowdown. Price declines that come from a downgrade to junk status are often material as many investors are forced to sell anything rated below investment grade. The investment-grade index is loaded with such candidates.

All of the facts above point to investment-grade bonds being an asset class that is riskier than it's been in the recent past, yet is paying a lower rate than before. It's hard to imagine that tailwinds that contributed to the strong performance in 2019 can continue into 2020. We will continue to focus on ensuring that our duration remains short and that we are confident in the credit profile of each underlying business we invest in. The volatility that could come from the points discussed above would be welcomed by us.

Preferred shares

It's rare that a conversation with financial advisors about income-producing investments doesn't turn to a question about preferred shares. In my opinion, the preferred share market is a prime example of an asset class that investors felt forced into as they struggled to generate yield in more traditional fixed income investments.

Preferred shares are an interesting beast. In general, they don't provide the maturity and covenants that most fixed income investors seek, but they have the ability to pay higher income than traditional investment-grade bonds. The higher potential yield is seductive to many investors, but since the financial crisis, the Canadian preferred share market had a difficult time generating attractive returns. As shown in the graph below, the long-term annualized return of 2.2% is likely not what most expected when they made their original investment.[v] Preferred shares are higher in capital structure than common stocks, but that hasn't protected investors from the three meaningful drawdown periods since 2007.



Source: Bloomberg LP. Total return measured in C$ as at December 31, 2019. The S&P/TSX Preferred Share Index is designed to serve the investment community's need for an investible benchmark representing the Canadian preferred stock market. The index is comprised of preferred stocks trading on the Toronto Stock Exchange. First decline: Feb. 26, 2008 to Dec. 23, 2008. Second decline: Nov. 21, 2014 to Jan. 18, 2016. Third decline: Oct. 3, 2018 to Aug. 27, 2019.

The chart above highlights that blindly buying preferred shares because of their relative attractiveness at the time of purchase doesn't always work out as planned. This doesn't mean that we never invest in preferred shares. In general, preferred shares are sensitive to movements in interest rates and in credit spreads for the underlying issuers. This can lead to volatility and to interesting opportunities that can be recognized only by those willing to do substantial credit work on individual businesses and invest in them when others are fearful. Our investment approach is well suited to acting in this manner and we believe that true active management will continue to uncover attractive investment opportunities in this market.

High-yield bonds

The high-yield credit market is another segment that has attracted new buyers frantically searching for yield. The U.S. high-yield index finished the year yielding just above 6%, which is certainly at the low end of its historical range.[vi]

The 6% headline yield masks an interesting dynamic in the current market. Many investors have begrudgingly allocated capital to high yield, but to protect themselves they stuck to only the highest-rated BB-bucket. Demand for what the ratings agencies have blessed as the safest high-yield bonds has pushed the yield on the BB index down to an all-time low of 4.38%.[vii] In fact, 46% of all high-yield bonds trade below a 4% yield.[viii] Many of the companies in this segment of the market are decent businesses, but is their yield properly compensating you for the credit risk? A quick look at a few examples in the high-yield market could raise some concerns.

It wasn't long ago that CBL Properties, one of the largest owners of malls across the U.S., was rated BB.[ix] CBL has since been downgraded and its bonds due in 2026 are trading at 60 cents on the dollar.[x] The juicy 5.95% coupon rate attracted buyers at issuance and it was touted for its relative attractiveness. Its relative attractiveness didn't include a discussion on potential changes in the underlying business. It didn't take into account deteriorating operating results and questionable asset allocation decisions by the management. The 5.95% coupon certainly didn't fully compensate you for the credit risk, and investors suffered because of it.

Here's another example. Frontier Communications Corp. was rated BB when it issued its 8.75% coupon bonds due in 2022.[xi] Many investors felt the high-single-digit coupon was attractive, especially when compared to the alternatives. Frontier is a telecommunications company providing internet, TV and phone services. Investors became accustomed to the "safety" of this business model and its ability to endure large amounts of debt. The "resilient business" and relative attractiveness of this bond didn't help investors as it now trades just under 50 cents on the dollar.[xii] Some of the largest issuers in the high-yield index are telecommunications companies that used debt to make acquisitions. Time will tell if they suffer the same fate as Frontier, but rest assured this isn't a space that generally attracts us.

I will admit to using two extreme examples, but they clearly highlight the risk of buying bonds that are relatively attractive from a yield perspective and deemed safe by others. Relative attractiveness only matters if you are certain you're going to get your principal back and these bonds are pricing in a scenario which may not occur.

However, all isn't lost in the high-yield market. When a large portion of the market is loved by investors and trading at historically low yields, there's bound to be a segment of the market that's being ignored. Most investors aren't interested in owning securities with economic sensitivity or a perceived risk factor.

In the last year, we had success finding investments that we believed were impacted by the market overreacting to that risk and, after thorough credit analysis, felt confident that these investments actually were attractive.

Fixed income and the active manager

The Toys "R" Us bankruptcy got us interested in looking at Mattel, Inc., while volatility surrounding the incessant trade war allowed us to invest in a large customs broker. After diving below the headline risk of each investment, we uncovered a solid business, enduring brands and valuable assets.

Generating ideas like these are the core benefit of a fundamental active manager. We will continue to look for investment opportunities based on our business and credit analysis, and not simply based on the headline yield and its relative attractiveness.

Fixed income has often been described as a negative art, where outperformance doesn't come from what you own, but from what you don't own. There seems to be an increasing amount of risk in yield-generating assets. I believe that future returns will be best achieved by avoiding some of the risks that the average investor seems happy to take, and ensuring that the risks you do take are built on a fundamentally driven investment thesis.

[i] Source: Ainger, John, "Bond World is Backing Away From All That Negativity as 2019 Ends", Bloomberg.com, Dec. 23, 2019. Accessed on January 3, 2020. https://www.bloomberg.com/graphics/negative-yield-bonds/

[ii] Source: Bloomberg LP. Bloomberg Barclays USD Liquid Investment Grade Corp Yield to Worst Index as at December 23, 2019.

[iii] Source: J.P. Morgan High Grade Bond and CDS 2020 Outlook, November 26, 2019

[iv] Source: "The 'BBB' U.S. Bond Market Exceeds $3 Trillion", SPGlobal.com, March 29, 2019. Accessed on January 3, 2020. https://www.spglobal.com/en/research-insights/articles/the-bbb-u-s-bond-market-exceeds-3-trillion. Bloomberg Barclays US Corporates BBB ex Financials Index used for BBB rated debt outstanding. Market value in US$.

[v] Total annualized return from December 31, 2007 to December 31, 2019 measured in C$

[vi] Source: Bloomberg LP.

[vii] ICE BofAML BB US High Yield Index. As at December 30, 2019.

[viii] Source: Kim, Jason & Sharan, Pranay, "GS Credit Insights: 2019 in Charts", Goldman Sachs Credit Research, January 3, 2020.

[ix] The security was downgraded by Standard & Poor's Financial Services LLC to BB+ on August 3, 2018 and was issued on December 13, 2016.

[x] Source: Bloomberg LP. As at December 31, 2019.

[xi] Source: Bloomberg LP. The security was issued on August 20, 2010.

[xii] Source: Bloomberg LP. As at December 31, 2019.

Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Please read the prospectus and Fund Facts before investing. Copies are available from your financial advisor or at **www.edgepointwealth.com**. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This is not an offer to purchase. Mutual funds can only be purchased through a registered dealer and are available only in those jurisdictions where they may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or specific investment advice. Information contained in this document was obtained from sources believed to be reliable; however, EdgePoint does not assume any responsibility for losses, whether direct, special or consequential, that arise out of the use of this information. Portfolio holdings are subject to change. EdgePoint mutual funds are managed by EdgePoint Investment Group Inc., a related party of EdgePoint Wealth Management Inc. EdgePoint® and Owned and Operated by Investors™ are registered trademarks of EdgePoint Investment Group Inc.

Published January 9, 2020.