Current market challenges call for an active and flexible high yield investment strategy

Stefano Perin
Credit, High Yield Portfolio Manager

Ariona Bundo
Investment Specialist

2016 KEY HIGHLIGHTS IN THE HIGH YIELD SECTOR

In contrast with favourable seasonality, the start of the year was characterised by an abrupt sell-off which lasted for the first 40 days on the back of global growth scare impacting negatively commodities prices and risky assets highly correlating in the downward movement. Macro data and stabilisation in oil prices by the end of February helped to recover from the cheapest valuations recorded since the second half of 2012. The market kept rising almost unrelentingly until the beginning of June when it started discounting the probability of an unfavourable outcome in the UK Referendum while collapsing for just a few days in the aftermath. At this point in time, the positive contribution from rates accounted for half of High Yield total return to date. In the first half of the year, we saw both deflationary and inflationary assets performing well: another counter-intuitive divergence which is typically associated with significant inflection points. In fact at the beginning of July we reached a peak in deflation expectations with an all-time low in interest rates: should this trend reversal prove lasting, then it has the potential to be the most important factor for pricing financial risk over the coming quarters. The impact on High Yield was evident later in the year when, after a hangover from overcrowding in BB-rated bonds, the market recovered awareness of its interest rates sensitivity. The same concept was further stressed upon US elections as valuations were less resilient to rising rates and steepening curves and credit spreads could not benefit from the Trump effect to the same extent as equity markets. This will likely lay the foundation for 2017 outlook.

WHAT TO EXPECT FROM 2017

As long as rotation out from deflationary assets unfolds, High Yield is not going to have the same tailwind from rates and search for yield as it was the case until recently. Therefore, in order to generate a meaningful excess return it will be crucial to distinguish between winners and losers from a credit standpoint, bond picking and implemented strategies. In such an environment, passive and tracking error constrained strategies might suffer, while cherry-picking active managers will have more opportunities.

> "We strongly believe that bottom-up bond picking, top-down levered beta and macro overlay strategies can be effective in capturing market upsides while smoothing potential drawdowns."

Another trend we will continue to watch closely is globalisation. Should the trend continue to slow or even recede, a renewed focus on stimulating domestic demand might favor small/mid caps compared to large multinationals. This would impact High Yield while creating various investment themes within the asset class. Due to different liquidity and lower informational efficiency compared to other financial assets, the High Yield market has a great potential in terms of fair value misalignments (therefore potential opportunities) and actionable trading ideas. This environment raises the case for a different approach to High Yield, whereas portfolio construction revolves around a high-conviction concept and it is balanced by a proactive stance in the management of market risk with the objective of limiting the exposure to downside episodes.

Therefore, in order to respond to the current market challenges in terms of increased volatility, market uncertainty and liquidity risk while being able to capture the asset class returns potential over the mid to long term, we strongly believe that bottom-up bond picking, top-down levered beta and macro overlay strategies can be effective in capturing market upsides while smoothing potential drawdowns.

OUR FLEXIBLE INVESTMENT SOLUTION

At Generali Investments, we decided to implement a new unconstrained and benchmark agnostic investment approach which is designed to answer investors' need for yield in a context of still extremely low interest rates. The strategy combines high conviction bond picking with a series of unfunded (long/short) strategies within a risk managed UCITS vehicle, the GIS Total Return Euro High Yield fund, and also through customised dedicated mandates.

Our investment team led by Stefano Perin in charge of High Yield bonds strategies, leverages on our strong in-house credit, equity and macroeconomic research teams.

We include in the investable universe not only Euro High Yield names but also cross currency deals. The bond portfolio will be complemented by macro long and short overlay strategies in order to achieve the desired flexibility, particularly in the context of a lesser liquid asset class such as high yield.

In summary, we offer an alternative, high conviction and flexible approach to more standard long-only strategies.