High yield: beyond the obvious

Focusing solely on credit research risks missing the bigger picture; investors could consider a global, macro-driven approach, while heeding the lessons of behavioural finance.

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Company research matters, but not in isolation

Credit research has long been the mainstay of active high yield investment. While clearly important, we believe that it should not be used in isolation.

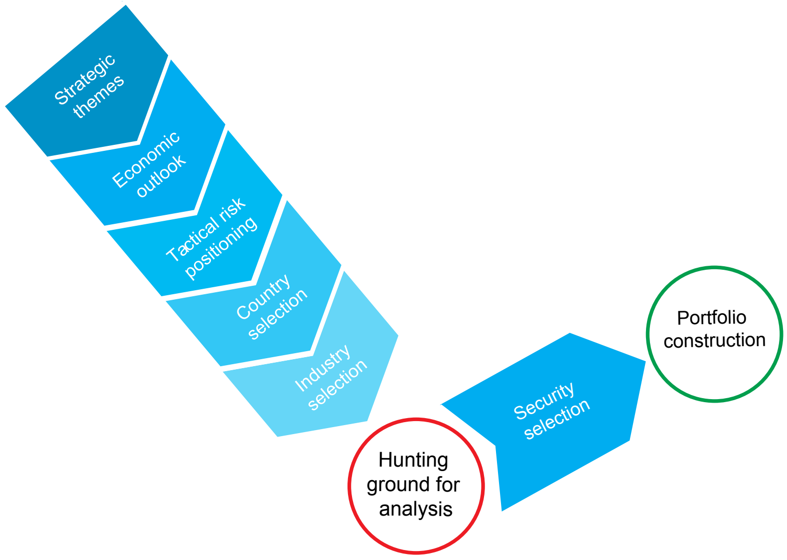
We differentiate our approach by letting our research be guided by the macro environment. In line with our global perspective on opportunities in the asset class, we also put store by filtering company names by region. Only at this stage do we begin detailed credit research, with an experienced team that follows a rigorous investment process. By debating ideas with the team and devoting time to understanding ourselves and our individual tendencies as investors, we also aim to avoid the pitfalls of behavioural biases

A macro-driven process

We believe that understanding the wider macro picture is crucial in generating attractive investment performance from high yield markets. Our macro view is therefore the starting point for portfolio construction, and is formed following regular meetings with in-house economists. Our experienced credit strategy team combines this guidance with their knowledge of the specific high yield market dynamics to form the team's overall macro view.

This perspective on the world not only guides how much credit risk we take but also where we take it. If our analysis of the range of potential outcomes suggests that a particular geographic region is undervalued by the market, we will focus our attentions there. Next, we use our macro conclusions to assess which industry sectors are most attractive. Only then do we look at individual company fundamentals and valuations, which themselves are always viewed in the context of the prevailing market environment.

Our rigorous, macro-driven investment process



Source: LGIM

Beware the emotion

When it comes to making good high yield investments, we believe there is little substitute for experience. Experience in a team means time spent learning from mistakes, and enables us to discover where our strengths and weaknesses lie. Emotion is core to our human nature, and behavioural biases are present in even the best investors. We therefore believe in a combination of knowing yourself and applying sustained critical thinking to avoid a variety of emotional biases.

One of the most frequent behavioural biases is confirmation bias, the tendency for investors to focus on information that confirms a pre-existing thought. Illusory superiority, the habit of investors to be overconfident in their own ability, is also common. Having our views challenged within the team aims to remove emotional biases such as these from our decision-making process; putting two minds to every problem is crucial. We also take a long-term view to avoid the recency effect: the habit of investors to put too much store by recent events. In addition, investors often devote a disproportionate amount of time to managing downside (loss aversion), which risks missing out on potential upside. We aim to consider both.

We are global

Emotional biases can relate to geographic location too. Most investors have a strong tendency to concentrate their investment portfolios in their own country, known as home country bias. While most individuals are aware of this, they are often reluctant to allocate a significant percentage of their capital outside of national borders, fearing unfamiliar investment names, different governance standards and additional currency risk.

By investing globally, we believe that we can offer our clients something genuinely different. We strive to avoid home country bias: US, European and emerging markets are all well represented in our portfolios. Our experienced team works closely together, but has global reach, being based in London, Chicago and Hong Kong. A worldwide focus allows us to reflect our macro views more efficiently and to provide diversified access to the best global issuers. Our macro approach leads us to filter company names by geographic location first, before selecting individual sectors and companies that stand out from a valuation perspective.

Crucially, the spreads available in different high yield markets often vary substantially by region. This means that global investors have the advantage of being able to access investment opportunities that may be significantly more attractive than those available in the domestic market. While we realise that there are risks associated with emerging markets, we also strongly believe that some of the best high yield investment opportunities are to be found in developing countries, and that emerging market high yield as an asset class will become much more important over time.

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