Credit selectivity at the fore in European high yield bond and senior loan investing

The European leveraged finance market is recognised for its potential to offer a compelling income advantage versus other, more traditional fixed income asset classes. Current market factors such as low default rates for speculative-grade debt and further stimulus from the European Central Bank are expected to continue to lend support to this asset class, which has enjoyed strong performance in 2019. Still, a prudent perspective would view the market as standing on relatively fragile ground in a period of low yields, lackluster economic activity and weakening growth outlook.

The Eurozone economy continues to face headwinds amid fears of a global economic slowdown. Declines in global trade, driven principally by U.S.-China trade tensions that continue to weigh on world economies, have put pressure on the manufacturing and industrial services sectors in Europe. Continued Brexit uncertainty also looms large over the UK economy and the Eurozone broadly. Add to this backdrop that much of the European government and investment-grade bond market is now in negative-yielding territory. This has driven investors further along the risk spectrum, resulting in a compression of spreads and limiting the income available to serve as a cushion to offset potential price declines. Investors face the challenge today of having to strike a balance between focusing on portfolio protection and finding investments that would provide a positive return.

It is Oaktree's view that such an environment calls for an increased emphasis on security selectivity. Judiciousness and risk control have always been part of Oaktree's investment approach, but considering the current conditions of the European leveraged finance market and reduced yields, we further stress the importance of basing investment decisions on shrewd credit selection.

Fundamental credit analysis: winning by not losing

Bottom-up fundamental credit analysis—a thorough study of issuers and determinants of their credit quality—can allow an investor to more deeply understand individual investments and identify good and bad credits. "Avoid the losers, and the winners will take care of themselves" is a longstanding conviction of Oaktree's and rings even truer today in considering the European leveraged finance market, where the cost of getting an investment wrong is high. Today, we see greater dispersion of single-name returns within high yield bonds.[1] With certain areas of the market plainly, if not dramatically, underperforming, we believe avoiding the losers is more important than identifying the winners (see table).

We consider fundamental credit analysis as one of the few things that can be known and practiced consistently in fixed income investing. Many drivers of returns in credit investing, such as changes in benchmark interest rates and central bank policy decisions, simply can't be known or predicted accurately. In addition, specific to today's low- and negative-yield environment—"the bizzaro world of global debt," to borrow the Financial Times' description—low yields and promise of new liquidity have brought about "yield tourists," who search outside of the typical investment turf to potentially capture extra returns.[3] These dynamics have contributed to distorting market currents, and the evolutions of such dislocations remain difficult to pinpoint. This we believe underscores the importance of focusing on what is knowable rather than attempting to position investments around unpredictable factors.

European high yield top 5 losers (LTM 30 November 2019)[2]

Name	Country	Sector	Coupon	Maturity	Price Fall
New Look	UK	Specialty Retail	8.00%	7/2023	(96)%
Senvion Holding	Germany	Machinery	3.88	10/2022	(91)
Thomas Cook	UK	Support-Services	6.25	6/2022	(89)
CMC Ravenna	Italy	Building & Construction	6.88	8/2022	(75)
Galapagos	Luxembourg	Diversified Capital Goods	7.00	6/2022	(68)

Source: ICE BofAML Global Non Financial High Yield European Issuers ex Russia 3% (EUR Hedged) Constrained Index

European senior loans top 5 losers (LTM 30 November 2019)[2]

Name	Country	Sector	Spread	Maturity	Price Fall
Doncasters	UK	Aerospace	E+825	10/2020	(70)%
PlusServer	Germany	Information Technology	E+375	9/2024	(50)
Syncreon	Ireland	Transportation	E+425	10/2020	(48)
Holland & Barrett	UK	Retail	E+425	08/2024	(45)
Bartec	Germany	Manufacturing	E+450	06/2022	(40)

Source: Credit Suisse Western European Leveraged Loan Index

Flexible mandates: capitalising on the knowable

Whilst credit selection remains at the absolute core of Oaktree's investing, we recognise that an understanding of closely related asset classes and of factors that drive dislocation adds another layer of opportunity. From this perspective, the latitude to cross the leveraged finance spectrum—covering both high yield bonds and senior loans—can be a valuable asset.

The distinction between the two buckets of non-investment grade investing has blurred over time, more recently with a significant rise in covenant-lite loans and an increase in secured bonds shares in high yield bonds. Having purview over both opportunity sets allows for diversified sources of returns, as well as the ability to tactically, and selectively, pivot across and within sectors and issuer capital structures to best capitalise on technical dislocations and relative value opportunities. For instance, whilst the spreads on European high yield bonds and senior loans are largely correlated over the longer term, the average spreads of similarly rated bonds and loans over the past several years have exhibited periods of substantial relative premiums and discounts that we believe a well-resourced investor could have taken advantage of.[4]

One driver of this anomaly is the dissimilar make-up of the underlying buyer base of the two sectors. Retail mutual funds account for 35% of the high yield bond investor base but are largely absent from the loan market.[5] This difference can affect capital-flow dynamics, particularly in volatile periods, and help create technically driven opportunities, something that investors with flexible mandates can capitalise on.

Amid risk and opportunity

Disciplined credit selection does not guarantee superior alpha in the short run, but we believe it is essential to achieving superior risk-adjusted returns over the long term. We anticipate the variables that are at play today—loose credit conditions and weakening global economic health, among others—will continue to shift and present a mix of risk and opportunity. In this landscape, investors should heighten their focus on avoiding the losers, but also be alive to the opportunities that volatility and dislocation can present. European high yields bonds and senior loans can offer the skilled manager differentiated return potential and serve as an attractive complement to other fixed income investments.

FOOTNOTE

1 Barclays Credit Research European High Yield. 20 September 2019

2 Oaktree does not currently own any of these bonds. The issuers mentioned are not an indication/reflection of Oaktree's holdings. The list of these investments are provided for illustrative purposes only.

3 'Negative bond yields spill into Europe's Emerging Markets,' Financial Times July 10, 2019

4 As of 31 August 2019. ICE BofAML Global Non-Financial High Yield European Issuers Ex-Russia 3% Constrained (EUR Hedged), Credit Suisse Western European Leveraged Loan Index

5 As of 1 March 2019. Source: S&P LCD, EPFR, ECB, Bloomberg, Bloomberg Barclays Indices, Barclays Research

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