For professional investors and qualified investors only

COLUMBIA THREADNEEDLE INVESTMENTS®

HIGH YIELD: ONCE AGAIN DOING WHAT IT SAYS ON THE TIN

Roman Gaiser
Head of Fixed Income and High Yield, EMEA

David Backhouse
Portfolio Manager, High Yield, EMEA

At a glance

- The extended period of low and near-zero interest rates from 2009 onwards saw European High Yield bond yields follow suit, reaching sub 3%
- But the subsequent move higher caught many investors unawares/off-guard, re-emphasising that volatility is often relatively short lived and the importance of watching longer-term trends
- With yields having become more attractive and volatility creating opportunities for active management, we believe current market conditions are a compelling opportunity for investors to reconsider their fixed income allocations

Issued June 2024

Introduction

In investing, where trends can shift rapidly and market conditions are ever-changing, the allure of fixed income was that it did what it said on the tin: stable and reliable returns. The global financial crisis (GFC), however, saw a transformation of the landscape marked by falling and persistently low interest rates and, subsequently, yields. Suddenly fixed income wasn't so reliable. But with that movement in reverse, we believe bonds could be a safer bet than equities over the next few years.

The high yield universe

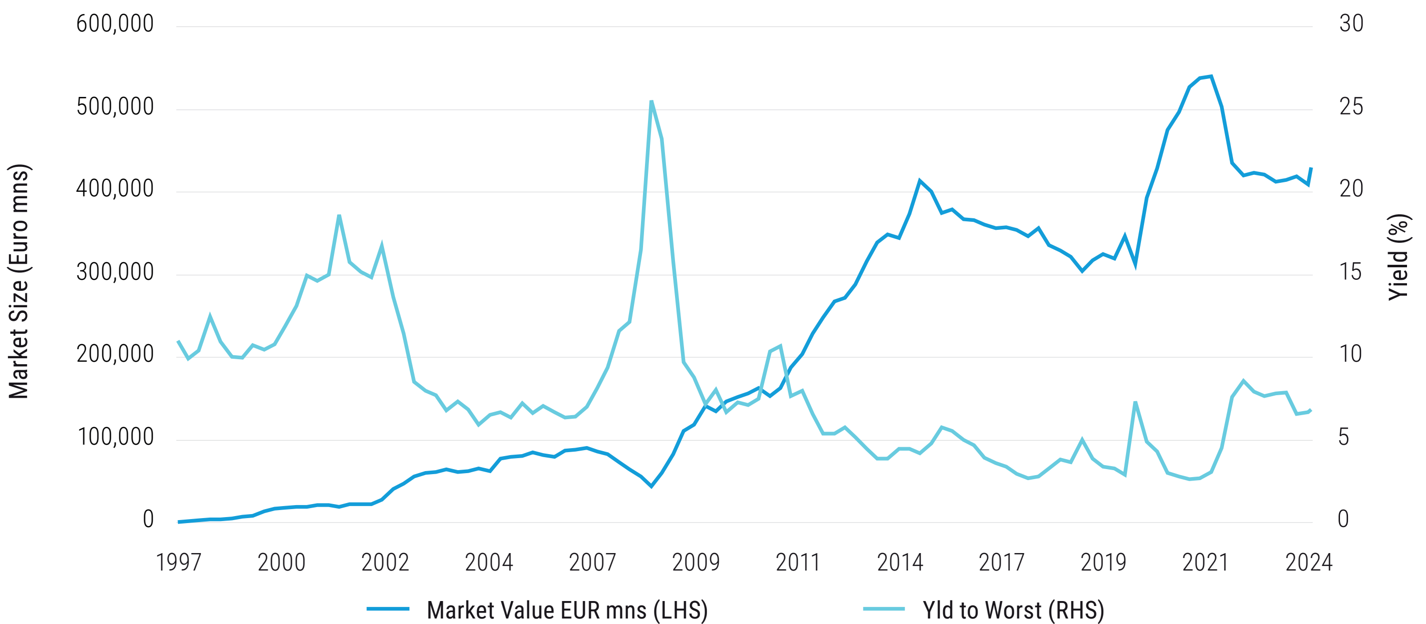
High yield as an asset class in European capital markets is around 25 years old. In some circles it might still be considered a bit of a marginal asset class – despite seeing more than two decades of sustained growth (Figure 1). Today in high yield, many of the companies generate at least €100 million in earnings and bring tranche sizes to the market of at least €500 million per bond (€250 million is the minimum size to qualify for the market). They include household names such as M&S, Avis, Land Rover, Asda and Virgin Media.[1]

Understanding market shifts: past to present

Quantitative easing policies introduced in the wake of the GFC sought to reduce volatility. Low and near-zero interest rates became the norm for more than a decade, with bond yields following suit. When interest rates once again started to rise it was a surprise to investors who had experienced nothing other than low rates and low yields. This meant that those who were long duration were not positioned for the move higher. In 2022/23 as yields went up quite dramatically – and the high yield universe is currently true to its name with yields of around 7%[2] – this hurt a lot.

The attraction of duration is that it gives you returns over several years: with a five-year 7% bond, for example, that yield is locked in over five years. If inflation continues to come off as expected, interest rates should also reduce. But duration means you have the opportunity to earn that higher yield for longer – all as yields elsewhere start to decline.

Figure 1: The European high yield universe



Source: ICE BoAML index HP00 European currency High Yield Index, as of 30 April 2024

[1] The mention of specific companies is not a recommendation to buy or sell

Credit spreads are less exciting, currently inside their long-term average. However, a compelling part of high yield is the breakeven return. This is effectively the cushion you get from a high yield product in a period of spread widening. Given where yields are, spreads are currently able to widen several hundred basis points before you start to lose money on a particular trade (Figure 2).

This is why fixed income investment is so interesting, and also why during that long, low period of volatility there wasn't much income left in many parts of the market. That has changed.

As we go through 2024 the economy is quite resilient. Data from the US is surprisingly robust and financial conditions are not particularly tight, which is supportive. Labour costs remain quite firm, with only regional signs of weakness. Inflation will, we think, remain higher than central bank targets. There are geopolitical concerns, which are a big driver of how we think about risk. Overall, however, we believe this environment, taken with improving yields, is a good entry point relative to recent history.

The longer-term is also promising, emphasising the importance of maintaining a balanced perspective and focusing on fundamentals. Indeed, with decades-long experience within high yield it can be seen that volatility is often relatively short lived, and what is really important are longer-term trends.

Active approach

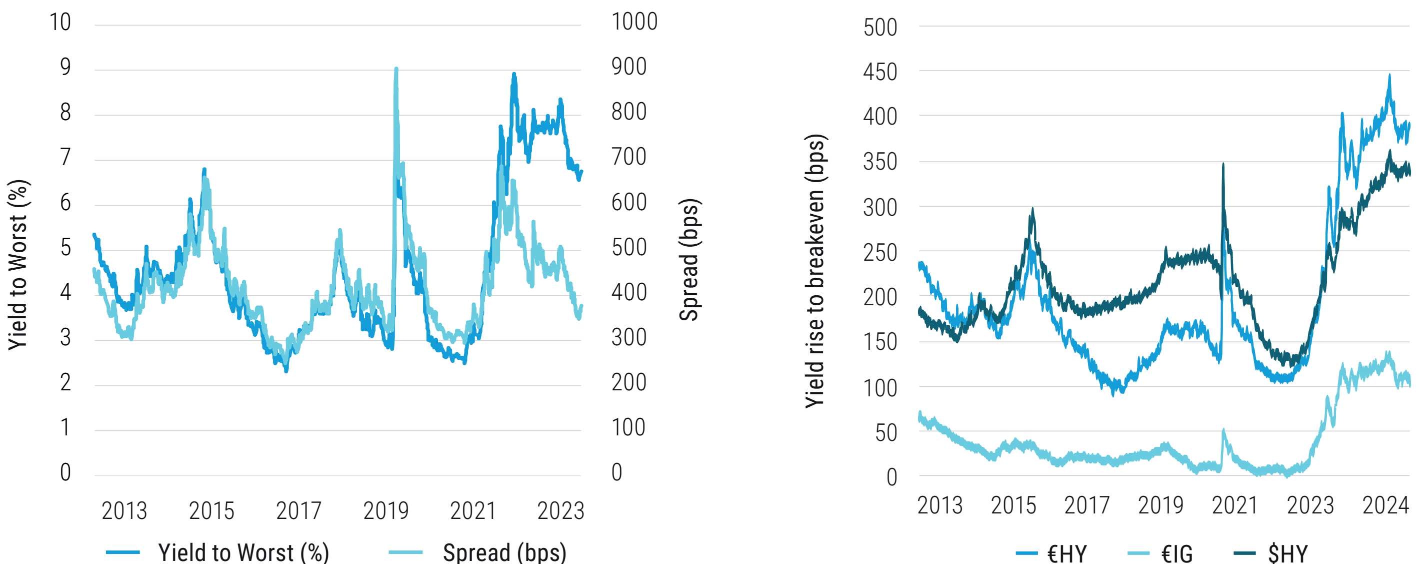
At Columbia Threadneedle Investments, we believe volatility provides opportunities when markets are temporarily weak. But the key to this is active management. The composition of bond indices is based on amounts of debt. If a company decides to increase its leverage, a passive investor effectively agrees to lend them as much money as the company wants – with the implied outcomes that brings. This isn't the case with active management, which allows us to pick and choose, to take advantage of market inefficiencies and really understand individual credits.

We aim to achieve this through thorough credit research and risk management. Our portfolio management approach – with collaboration between portfolio managers, dedicated high yield analysts and broader investment analysts – combines investment research, responsible investment criteria and risk analysis to identify low-risk names with strong performance potential. We are looking for the inconsistencies in ratings that could allow us to buy a single B-rated company and see that upgraded to double B, and this meticulous process has enabled us to consistently deliver over the long term while maintaining lower volatility.

Conclusion

Current market conditions present a compelling opportunity for investors to reconsider their fixed income allocations. With yields becoming more attractive and volatility creating opportunities for active management, now is an opportune time to explore high yield investments. At Columbia Threadneedle Investments, our global reach, research intensity and commitment to responsible investing mean we are well placed to navigate the complexities of the fixed income landscape, helping investors position themselves for long-term success amid a changing investment landscape.

Figure 2: European High Yield valuations (LHS) and breakeven rates (RHS)



Source: Bloomberg and Columbia Threadneedle Investments as at 31 March 2024. Breakeven rates are calculated by dividing the index yield to worst by index adjusted duration. Index adjusted duration is calculated by taking away 1 to account for rolldown. This breakeven shown gives an indication of how much yields can rise before the initial yield of the market is wiped out.

[2] ICE BoAML index HP00 European currency High Yield Index, as of 30 April 2024

To find out more visit **columbiathreadneedle.com**

Important Information

For use by professional clients and/or equivalent investor types in your jurisdiction (not to be used with or passed on to retail clients). For marketing purposes.

This document is intended for informational purposes only and should not be considered representative of any particular investment. This should not be considered an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Investing involves risk including the risk of loss of principal. Your capital is at risk. Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. The value of investments is not guaranteed, and therefore an investor may not get back the amount invested. International investing involves certain risks and volatility due to potential political, economic or currency fluctuations and different financial and accounting standards. The securities included herein are for illustrative purposes only, subject to change and should not be construed as a recommendation to buy or sell. Securities discussed may or may not prove profitable. The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Threadneedle Investments (Columbia Threadneedle) associates or affiliates. Actual investments or investment decisions made by Columbia Threadneedle and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Information and opinions provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. This document and its contents have not been reviewed by any regulatory authority.

In Australia: Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414. TIS is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) and relies on Class Order 03/1102 in respect of the financial services it provides to wholesale clients in Australia. This document should only be distributed in Australia to "wholesale clients" as defined in Section 761G of the Corporations Act. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws.

In Singapore: Issued by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore.

In Hong Kong: Issued by Threadneedle Portfolio Services Hong Kong Limited **天利投資管理香港有限公司**. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058.

In Japan: Issued by Columbia Threadneedle Investments Japan Co., Ltd. Financial Instruments Business Operator, The Director-General of Kanto Local Finance Bureau (FIBO) No.3281, and a member of Japan Investment Advisers Association and Type II Financial Instruments Firms Association.

In the UK: Issued by Threadneedle Asset Management Limited, No. 573204 and/or Columbia Threadneedle Management Limited, No. 517895, both registered in England and Wales and authorised and regulated in the UK by the Financial Conduct Authority.

In the EEA: Issued by Threadneedle Management Luxembourg S.A., registered with the Registre de Commerce et des Sociétés (Luxembourg), No. B 110242 and/or Columbia Threadneedle Netherlands B.V., regulated by the Dutch Authority for the Financial Markets (AFM), registered No. 08068841.

In Switzerland: Issued by Threadneedle Portfolio Services AG, an unregulated Swiss firm or Columbia Threadneedle Management (Swiss) GmbH, acting as representative office of Columbia Threadneedle Management Limited, authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

In the Middle East: This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Market Counterparties and no other Person should act upon it.

This document may be made available to you by an affiliated company which is part of the Columbia Threadneedle Investments group of companies: Columbia Threadneedle Management Limited in the UK; Columbia Threadneedle Netherlands B.V., regulated by the Dutch Authority for the Financial Markets (AFM), registered No. 08068841.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. columbiathreadneedle.com CTEA6629167.1 | WF2199444 (06/24)