THE CASE FOR EUROPEAN HIGH YIELD BONDS

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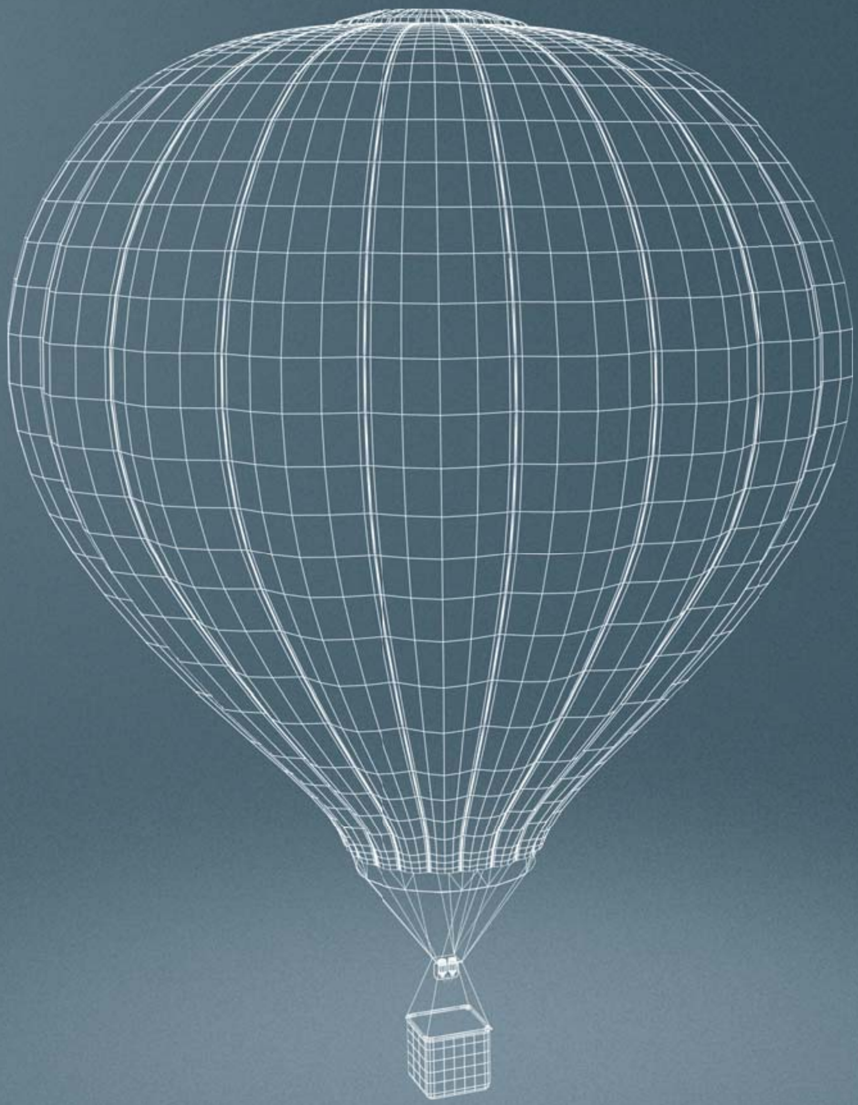


For professional investors only

The case for European high yield bonds

High yield bonds have been a staple of US portfolios for more than 30 years. The trends that have led to this large and well-developed US market are now firmly establishing themselves in Europe as companies turn to high yield bonds as a source of funding. Investors are also increasingly coming to recognise the favourable risk/return and yield characteristics of the asset class and allocating to high yield bonds as part of a balanced portfolio.

Why high yield?

High yield bonds are corporate bonds that carry a sub-investment grade credit rating*. They are typically issued by companies with a higher risk of default, hence the higher yields. We believe the following factors combine to make European high yield bonds an attractive investment:

- Established and deepening market
- High income in a low yield world
- Low sensitivity to the interest rate cycle
- Default rates expected to remain low
- Significant opportunities for credit selection

*Bonds rated equal or lower than: Ba1 by Moody's or BB+ by S&P or Fitch.

An established market

As the table below shows, the European high yield bond market has more than trebled in size in the last 10 years. The financial crisis accelerated this trend as banks curtailed their lending, encouraging companies to seek other sources of long-term financing, such as issuing high yield bonds.

Fig 1: High yield market is expanding and diversifying

	2006	2011	2016
Market value €bn.	87	163	357
Number of issues	221	415	620

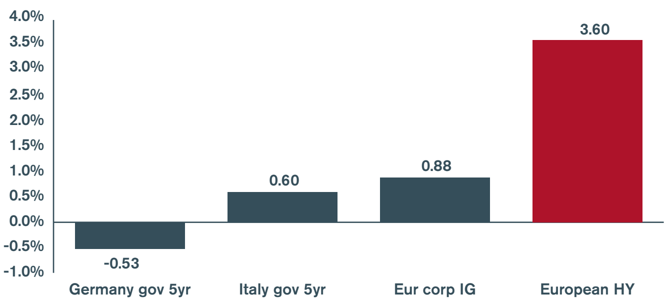
Source: Bloomberg at 31 December 2016, End of year figures for BofA ML European Currency High Yield Index (HP00).

Today, the European high yield market comprises a vast range of companies from household giants, such as Fiat, Tesco and Telecom Italia, through to small and medium-sized companies that are raising funding via the bond markets for the first time. This creates an attractive mix of issuers that can reward strong credit analysis.

An attractive source of income

Yields have been driven to low levels by low central bank interest rates combined with unconventional policy measures. This includes central banks such as the European Central Bank agreeing to regular purchases of government and corporate bonds to help keep financing costs low. As Fig 2 shows, high yield bonds offer a strong yield pick-up compared with other forms of debt in Europe.

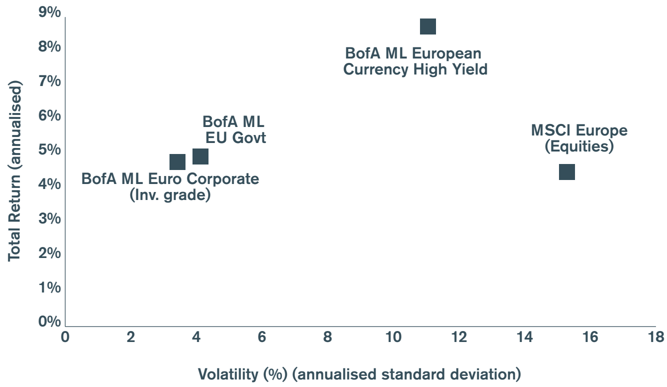
Fig 2: High yield is a source of attractive yield



Source: Bloomberg, at 31 December 2016, BofA Merrill Lynch at 31 December 2016, Eur Corp IG (investment grade) = ER00, European HY (high yield) = HPIC. Yield to maturity for government bonds, effective yield for corporate bonds. Yields may vary and are not guaranteed.

From a risk-return perspective, high yield bonds are typically seen as occupying the space between investment grade bonds and equities. As Fig 3 shows, over the last 15 years, European high yield bonds have outperformed investment grade corporate bonds, government bonds and even equities, with less volatility than equities. The high income element in high yield bonds has been a valuable component of total return.

Fig 3: Total returns vs volatility, 2001-2016



Source: Thomson Reuters Datastream, 31 December 2001 to 31 December 2016, total return indices, in euro. Volatility is standard deviation, using monthly data returns.

Past performance is not a guide to future performance

Low sensitivity to the interest rate cycle

High yield bonds are typically less sensitive to rises in interest rates or inflation because the spread (additional yield over equivalent government bond) often acts as a cushion, absorbing some of the rise in yields when government bond yields or interest rates rise. The short maturities on European high yield bonds together with reasonably high coupons makes them low duration. The average effective duration on European high yield bonds is 3.4 years, compared with 5.3 years for European investment grade corporate bonds and 4.3 years for US high yield bonds[1]. While this creates reinvestment risk when yields are falling, in a rising yield environment the shorter duration can be advantageous.

[1]Source: Bloomberg, at 31 December 2016 BofA Merrill Lynch High Yield Indices, Europe High yield = HPIC, Europe Investment grade = ER00, US high yield= HUC0.

High yield also tends to exhibit a higher level of idiosyncratic risk than other areas of fixed income, with individual company factors proving a more significant determinant of the bond price than is the case for investment grade bonds. As the correlation table below demonstrates, European high yield also has a stronger correlation with equity markets, making it a useful diversifier within a fixed income portfolio.

Fig 4: Correlation of asset classes (2001-2016)

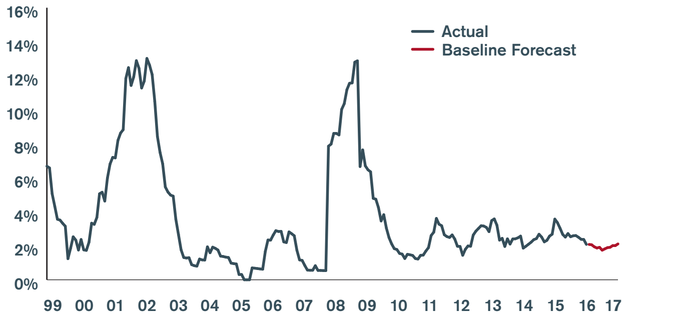
	Euro HY	Euro IG	Euro. Govt.	Euro. Equity
Euro HY	1.00			
Euro IG	0.54	1.00		
European Govt.	-0.06	0.61	1.00	
European Equities	0.68	0.27	-0.14	1.00

Source: Thomson Reuters Datastream, Henderson Global Investors, 31 December 2001 to 31 December 2016, Euro HY = BofA ML European Currency High Yield Index, Euro IG = BofA ML Euro Corporate Index, European Govt = BofA ML European Union Govt Index, European Equities = MSCI Europe Index, correlation coefficients of monthly total returns in euro. **Past performance is not a guide to future performance.**

Default rates expected to remain low

For a long-term investor, the heightened risk of default is the key driver of spread premia for high yield bonds. We expect European defaults to remain low for an extended period given the current environment of sensible leverage, low capex and historically low interest rates.

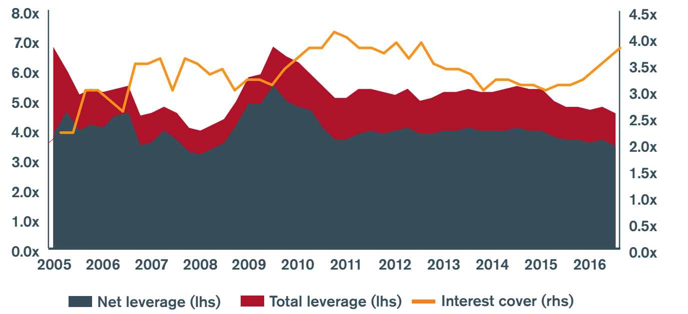
Fig 5: European speculative grade default rate, trailing 12 months



Source: Moody's Default Study, 31 December 1999 to 31 December 2016. Forecast at 10 January 2017 for the year to 31 December 2017.

European companies are arguably at an earlier stage of the credit cycle than the US. Following the financial crisis in 2008, authorities in the US were quick to apply unconventional measures to stimulate the economy. Europe was slower to engage in this process and its domestic economy and companies are playing catch-up. Slower economic growth and concerns about the economies in the periphery of the Eurozone led to more conservative financing among European companies. In recent years, European issuers have continued to strengthen their balance sheets, with leverage falling and interest cover rising as shown in Fig 6.

Fig 6: European high yield credit fundamentals



Source: Deutsche Bank, Markit, Factset, 31 March 2005 to 30 September 2016. Interest coverage is EBITDA/Interest Expense, while Total Leverage is Total Debt/EBITDA and Net Leverage is Net Debt/EBITDA. EBITDA = Earnings before interest, tax, depreciation and amortisation.

Net European high yield supply is expected to be low in 2017. Low yields might be expected to act as an incentive for companies to borrow, and there has been a high level of refinancing of existing borrowing in this market.

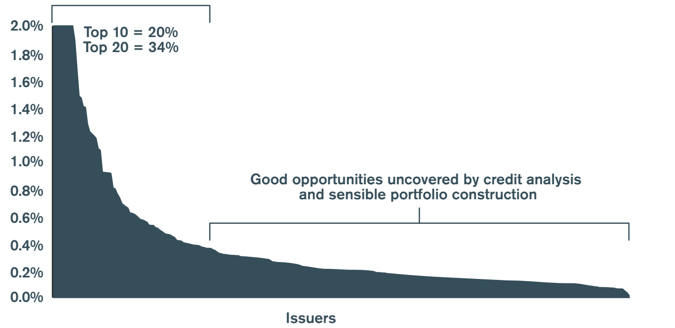
Yet there has been limited appetite for additional borrowing among European high yield issuers, underscoring the structural improvement in balance sheets. The demand side of the equation also looks favourable given the ongoing search for yield among investors and central banks remaining active buyers of corporate bonds.

Significant opportunities for credit selection

The high degree of idiosyncratic risk in high yield bonds means good credit analysis is rewarded, making it fertile ground for active managers.

Under-researched issuers. Bonds trade over-the-counter (OTC) rather than on standard exchanges. The lack of transparency in the OTC market means exchange-traded funds (ETF) and larger investors are forced to focus the bulk of their trading activity on the larger issuers. This leaves a wealth of opportunities for active investors, such as Henderson, to identify value among smaller under-researched issuers.

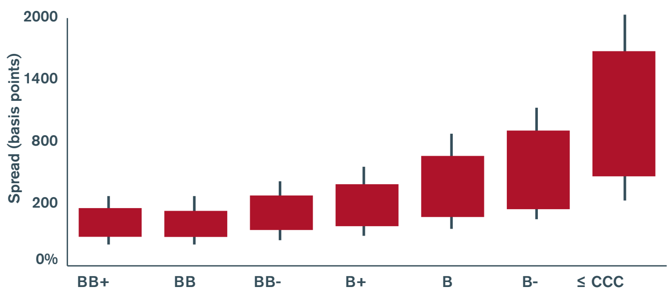
Fig 7: Issuer weights in the European high yield index (HPIC)



Source: Bloomberg, BofA ML European Currency Non-Financials 2% Constrained High Yield Index (HPIC), at 31 December 2016.

Breadth within each rating band. The market can hold very different views about issuers within the same rating band as demonstrated by the wide credit spread range in Fig 8. This means that within high yield, it is possible, through careful credit research, to profit from mispricing or volatility in the credit spread.

Fig 8: Range in spreads offers opportunities



Based on BofA Merrill Lynch European Currency High Yield Index (HPIC) as at 31 December 2016. Chart shows the interquartile range (red box) and 5th/95th percentiles by rating category (grey line).

Ratings mismatch. Within the credit cycle, ratings agencies tend initially to review the larger issuers, taking time to progress to the smaller, often lower-rated issuers, so can be slow to appreciate improvements in CCC rated issuers. We also believe that since the financial crisis, ratings agencies have sought to deflect criticism that they were too generous before 2008 by applying a cautious bias to ratings in recent years. Again, this allows credit analysis to identify mis-rated opportunities.

The case for European high yield bonds

Risk considerations

High yield bond holders rank above equity holders in the capital spectrum and therefore have a superior claim on the company's assets. High yield bonds are, however, issued by companies where there is a higher risk of default. The main risks facing high yield bond holders are:

- **Default risk:** the risk that an issuer fails to meet its payment obligations – the coupon and/or the final maturity payment. In some cases, the bondholder may be able to recover unpaid coupons or the final maturity value of the bond but in the worst case scenario an investor could lose the capital invested in the bond.
- **Downgrade risk:** if a bond's credit rating is lowered, this is likely to lead to a lower price for the bond as investors in the market demand a higher yield to hold the bond.
- **Interest rate risk:** while high yield bonds are typically less sensitive to rises in interest rates than investment grade corporate bonds, they are not wholly immune to rate movements. A large rise in interest rates or government bond yields is likely to push up the yield on high yield bonds (causing the price of existing high yield bonds to fall).
- **Liquidity risk:** the high yield on high yield bonds also seeks to compensate for possible illiquidity – difficulty in trading the security. During times of market stress, it may be difficult to find a buyer for a bond at an acceptable price, which could lead to a loss for the bondholder.

Accessing the asset class

For information about the high yield strategies that Henderson manages, please visit the Henderson website or use the contact details below.

* Source: Henderson Global Investors, as at 31 December 2016.

European High Yield Portfolio Managers

Stephen Thariyan
Global Head of Credit

Stephen Thariyan is Global Head of Credit, in charge of the 36-strong* credit team of portfolio managers and analysts at Henderson. Prior to joining Henderson in 2007 as Head of Credit, Stephen was a portfolio manager at Rogge Global Partners responsible for investing in corporate bonds and credit derivatives globally. He was previously a director and senior analyst at NatWest Markets' credit rating and research unit where he led teams of sector analysts in credit research. He started his career as an accountant at Ernst & Young in 1988 and later moved to become senior auditor at Chevron Corporation.

Tom Ross, CFA
Portfolio Manager

Tom joined Henderson in 2002 and has been co-managing Henderson's absolute return credit funds since 2006. Prior to this he specialised in credit trading on Henderson's centralised dealing desk. Here he was able to build strong relationships with market participants in order to gain flow and positioning information to supplement credit views. In August 2015 he became a co-manager on the Henderson Horizon Euro Corporate Bond, Euro High Yield Bond and Global High Yield Bond funds.

Thomas Hanson, CFA
Portfolio Manager

Thomas Hanson joined Henderson in October 2015 as a Portfolio Manager. Prior to joining Henderson, Thomas was a Senior Credit Portfolio Manager at Aerion Fund Management. He co-managed the sterling investment grade corporate bond portfolio for the National Grid pension scheme, totalling £4.9bn. Thomas started his career at Lazard Asset Management, where he spent 14 years, and became the lead portfolio manager for all sterling fixed income strategies and a senior portfolio manager for European investment grade and high yield funds.

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested.

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