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A SIMPLE THEORY

EINSTEIN'S LESSON FOR INVESTORS

ROBERT BALTZER, SEPTEMBER 2022

The value of any investment can fall as well as rise and investors may not get back the amount invested.

Albert Einstein observed that simple is often best. Here, Robert Baltzer explains why this is true when it comes to investing in high yield bonds.

The phrase “everything should be made as simple as possible, but not simpler” is often attributed to Albert Einstein (although it paraphrases his actual quote). In essence, his observation is that complexity impairs our ability to understand the world. As a result, we should endeavour to simplify our ideas as far as we can without compromising their integrity. This is how we think about investing in high yield bond markets.

Financial markets are complex systems, and our collective ability to predict the future is clearly limited. For all the time spent pondering ‘known unknowns’ – how much gas will Russia supply to Europe? What impact will inflation have on aggregate demand? – markets continue to be surprised by ‘unknown unknowns’ like the Covid pandemic or the invasion of Ukraine. Few could have confidently predicted these events and so, rather than being distracted by the chatter of complex and changing macroeconomic news, we have long advocated a calm, steely focus on long-term return opportunities and company fundamentals. In our view, the best way to deliver attractive returns for our clients in high yield bonds is to seek resilience from our investments. We do this by identifying a diverse range of distinctive opportunities and ensuring the companies in which we invest are robust and adaptable. This is still no easy task, but it is as simple as we can make it.

Today’s environment, characterised by tightening monetary policy, high inflation, supply chain disruption, elevated uncertainty and the resulting increased cost of capital, has been challenging for riskier assets. In the context of the high yield market that means bonds with longer maturities, those that are subordinated, or where the issuers are less mature businesses have been under pressure. We own some of these in our high yield portfolios, and believe these positions continue to offer attractive long-term return opportunities that go unrecognised or misunderstood by the wider market.

For example, we own bonds issued by the UK’s leading independent vehicle leasing, fleet management and outsourcing business, Zenith. Those that take a top-down view might look past Zenith, dismissing it as a small, low-rated business which serves other companies and is reliant on wholesale funding. Unsurprisingly then, Zenith’s bonds have been at the sharp end of the recent sell-off, offering a yield well above similar high yield bonds. As bottom-up investors, we take a different view and believe the valuation has moved out of sync with company-level fundamentals. Zenith has a track record of growth and resilience, along with an experienced and capable management team. It also has the support of banks, which value its expertise and understand its collateral pool well. We believe Zenith will continue to deliver steady and predictable growth as it leverages its well-established customer relationships and pursues an electric vehicle strategy ahead of its competitors.

Another example is the corporate hybrid bonds issued by European real estate company Heimstaden Bostad. The company owns, develops and manages residential homes in markets where there is a structural shortage. These strong fundamentals mean that, while the hybrid bonds are subordinated to the company's senior BBB-rated debt, we believe the default risk is low. However, the issuer can choose to defer the date at which the principal is repaid, making them highly sensitive to market sentiment and interest rate expectations. As a result, Heimstaden's hybrid bonds have exhibited high volatility in the past six months.

Ultimately, we believe this company has the financial strength to repay its debt on the expected timeline. Therefore, we believe the BB-rated hybrid bonds offer an attractive yield for the rating and relative to the senior bonds.

As patient investors, we are willing to take meaningful positions in the best long-term return opportunities and look through short-term market gyrations. While the resulting volatility might be uncomfortable at times, experience tells us this is an effective route to delivering outperformance for client portfolios. We've made it simple: we are focused, not frantic.

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