ROBECO High Yield Bonds Special Update

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Call Transcript:

Good morning and thank you for dialing in during these challenging times to hear what we have to say. So last Friday we sent out a piece saying we are increasing our beta and in this presentation, I wanted to give you a bit more insight as to why we are doing it, what we are seeing, and what the potential risks are on the market. I presume you have the presentation in front of you.

Slide number four is investment summary so this is the time to increase exposure to High Yield and that is a pretty bold statement. As alluded to we are very conservative but we are also extremely contrarian. So when things are going wrong and you are compensated for the risk, we want to step in. If you look at the slides, We have increase the beta to around 1, we were at 0.9 around 2-3 weeks ago. We increased that and within the team, our risk appetite has increase. Valuations are very compelling spreads are well above average and will probably move a bit wider as well. If you look at what is being priced in today, it's really a global recession but we think finally you are being compensated for it. Also in times of extreme panic, you should be contrarian. What is also a big thing in the market is that markets are extremely illiquid. So we are advising slides to build up exposure via funds.

The Market Views

We look at the market and we know we have been bareish on the market some would say too bareish but the reason is due to slide number 6. If you look at the S&P 500, the January and December figures, it was already nearing recession. Next to that, with the coronavirus, I think these numbers which you are seeing today are positive numbers because it will get much worse. Also, the US is in an industrial production recession and also this will continue to go down as well. So this is one of the main reasons why we're so cautious on the high yield market. If you zoom in to the debt market in general on slide number 7, this is no news that the debt market has been increasing quite rapidly after 2009. This time it's really a corporate bubble, a lot of companies have been issuing quiet some debt to do MNA and net share buyback as you can see on the slide. There's a state-of-mind in fixed income market lots of companies trying to reward their shareholders and that's where most of S&P return came from and that's typically not a good environment for credit investors, like ourselves. So that is why we were so cautious. Also, if you look at how the state of companies was until the coronavirus broke loose on slide number 8 is that leverage was trending again and for leverage you want to be compensated. If you look at the US net leverage numbers (on right hand side) after quite some decline, which was positive, it's been going up again. If you look back in history, this is now one of the widest net leverage numbers we've seen. You have to relate that also to what spread was trading at the time, which was 300, then you can imagine we were not overly bullish on our asset class. A different picture for Europe, European leverage was trending down but it also related to the fact that they had a bit more liquidity on their balance sheets and they weren't investing on their businesses so that's a long term negative but for now if you look at net leverage between both regions, Europe is definitely doing better. I cannot go away from fundamentals and not discuss the oil market, I think this is one of the main triggers why the market is in such disarray. The war between Saudis and Russia has pushed prices back to 2015 levels, I think most of you remember what happened to equity markets but especially to High Yield markets, negative sales return years. If you look at slide number 9 (sorry the headers are wrong) but if you look at the left hand graph, its 2015 all over the place so big price drops for the empty space still around 10-15% of US High Yield market and on the right hand side you see some of the decline in the bigger, old players like OAS and WLL dropping more than 60% and these are bump prices. SM energy, you see some of the bigger players like CHK all dropping like stone and if you just google or look in Bloomberg as to what petroleum is trading, now it's trading at 15, if you look at what it was trading 2-3 weeks ago it was closer to 60. So significant price drops, we have been very much underweighted space but this explains partly where the pain in High Yield is coming from and again this feels like 2015. What will happen going forward? Well, I think a lot of companies will try to cut their capex, which is a longer term negative of course. It could also draw under revolvers and then use that for spending which will not increase their liquidity or positions. They could also do asset disposals but we think that's highly unlikely in this current market environment. The only positive thing which is happening now for the oil players and the gas players is most of their forward hedges are positive so typical players have been hedging between 70-90% of their production in 2020 and of course much higher levels so that's a benefit but if you look at the hedging for the next year or so that's almost 0 so there is a lot of pain to come to expect more in restructuring cases. So that is the fundamental side.

Valuations

This is where it's really happening today slide number 11 is just a simple table of where credit markets are trading vs their long-term and median. If I had to show you this 4 weeks ago, everything was at the median or slightly below and now you see that for instance US High Yield but also EUR High Yield is trading at a 1.6 times the long term median. Lots of widening, something we've seen. Some markets are definitely looking far more interesting, that's also one of the reasons why we have been increasing our risk. We're not fully overweight but we have been increasing. If you want to make the case, why should you go long High Yield, obviously I do acknowledge all the pain you guys had on your equity portfolios, but if you look at where those returns are on slide number 12, for government bonds and this is year-to-date in the US, they're up almost 7% in dollar terms. Germany is 5% up. And if you look at where the liquid HY ETFs are trading until Friday US HY down -11% and Euro HY down -13%. That's almost a 15-20% gap between risk-free and HY and I think that gap is extremely wide. Also rates are going to 0 or are at 0 already. So in this case we would say go for spread and go for carry because how much lower can spreads go on government bonds. Now on slide number 13, where there any warning signs? Well I think most of you know that we are always very objective over our own asset loss so if we see warning signs we would definitely tell so. Even when the market was trading at the beginning of the year at a spread of 300, there were early warning signs available. Slide number 13 shows you two. First of all, the single B curve 1-3 yrs. was trading over the longer curve so there was an inverted curve already and that typically happens when you go into a bear market. And it was quite surprising it didn't happen already because markets were still pretty bullish but as you can see we are now entering a bear market. So that was one of the first early warning signs we typically looked at. Then the other part was that the distress count was moving up, it was outpacing the spread trends we saw in US HY and that's quite surprising that you see a lot of idiosyncratic risk in the markets much more distress issuers trading above 10% but the overall market wasn't really reacting. Market spreads are moving quite rapidly up today and that's also something you see reflected on slide number 14. A very simple graph where we plug global HY versus the long term avg and the long term median. Well finally it is well above the average of course a big market shock which you also saw before that HY was trading well below the long term average and that's what it's typically doing. It never trades at the average, it trades below or well above and we would say that at these levels anywhere between 700-900 bps HY is looking very attractive and that's all because of the coronavirus and the oil war between the Saudi &

Russians. Another interesting thing to look at is how you compare HY with IG because I think that's also a main topic. On slide number 15, if you look at this graph we plugged Global HY vs Global IG and these are yield to worst. One thing you can clearly see is the purple line, the ratio between the two, that HY is massively underperforming versus IG. How is that possible? Well obviously IG is a high duration asset loss for the US it is almost 8 years. The duration for HY was 3 years, it is now 4 a because a lot of bonds are no longer trading to coal and this is the main reason why the HY market is underperforming and also spreads have been moving up in a much higher fashion as compared to IG markets. So only look at this yield ratio, HY looks very attractive at this point in time. Continuing to slide 16, as you know we are a global HY manager so one of the ways for us to add value is to play the two regions. Developed markets in this case, the US and EUR, and for a while EUR HY was out performing the US purely because of the ECB, there started buying in October. If you look at the market today, markets are puking and I think it's been both as hard in the US and EUR so that doesn't really matter. It's all about fear, it's about illiquidity and spreads are moving up quite rapidly. With the rate cuts by the feds, you do see that hedging cuts are taking a nose dive on the right hand graph. This could in the end impact international flows while EUR HY looked more interesting but now with hedging costs stepping away I would make the argument that US HY is also beginning to look very interesting as well. Double BBs were outperforming triple CCCss no matter if the market was in a better mood or not. Double BBs was the place to go for most investors, if you look at Q1 (updated Friday) you do see that spreads are widening but triples CCCs are outperforming. So most of the pay is now in higher quality paper. Another way to put it is if you look at the spread differential between triple BBBs and double BBs, it was trading at a historical low around 50 bps. For us, it was also the reason why we onboarded a lot of investment grade risk in our portfolio. 2-3 weeks ago we had around 17-18% in investment grades which sounds a bit weird for a global HY manager but the reason we did that here was on the graph, the reason double BBs and triple BBBs spread was extremely low and it offered us a very nice liquidity pool and as you can see the trade really worked because double BBs are widening massively versus triple BBBs. So if I were to come to a conclusion on slide number 18, and I do take a preemptive stance here because we do have our credit outlook this Thursday, I would say on a fundamental angle we are still cautious so I am not expecting any changes there. We move from cautious to constructive. We think that markets, especially HY are extremely cheap and technical this is the biggest debate because of the monetary policy or should you move that to a more neutral stall because of all the forced outflows and the illiquidity for now I put it here as a constructive. Beta is neutral, you can see green checkmark on slide. So if spreads were to move even further, we would definitely move it to a more constructive phase. And again we prefer HY over IG. With financials vs. non-financials, there is no real preference. There is also a statement I would like to make on the liquidity in the market, and I think most of you do feel it, HY but also IG is extremely liquid and it's very difficult to trade. If you bid asks of 10 points, that seems to be the new normal than even executing in volume is quite difficult. So we have increased the beta of our funds but we have used credit derivatives, so CDX HY and Itraxx cross over, which is still manageable, you can do size the bid ask still ok, but trading cash bonds is extremely difficult and that's what it is today. Then I'll go into the positioning in a bit more detail. As I've said we haven't been doing too much of trading in the cash side, it is very difficult and on slide 20, for most of you his is very familiar. This is sector positioning. I think the biggest takeaway here is we are underweight in energy mostly US energy, we have 8% exposure and out of that 4% is IG-rated. If you look at it in terms of risk or duration time spread, energy is our largest risk underweight and it is definitely helping our relative performance. From the other sectors, still cautious to telcoms if you are bit more cynical telcoms are actually doing quite well in a risk-off scenario, That's also where we're seeing a bit of underperformance coming from but most of the positions have been quite stable because also trading has been structurally impossible. Then if you look at slide number 21, we still have a small EUR HY gap versus the dollar market, the dollar underweight is definitely coming from our underweight in triple CCCs so no big changes over there. But over the course of the last ten days, we've been adding risk using credit derivatives. We do have a preference for EUR HY because you do see that Itraxx cross over has been significantly underperforming with CDX HY so we think that the crossover space looks more interesting from the derivative side and that the HY market has a big further to go in the US, that's why we prefer to take a long position using Itraxx cross over. If you go to the rating allocation, I think it's very important to highlight: yes we are a global HY fund but we are very much quality tilted and what you can see on slide number 22 (end of Feb numbers) 16% allocations to triple BBBs, I can tell this is really helping our performance at the moment and offers us a nice liquidity pull. We have a small overweight in double BBs but if you go further down the structure, there's a very big underweight and again this should help our performance going forward.

I'll go straight into the beta, again these are older numbers (end of Feb) but I've closed with the little dot, this is where the beta is at the moment. It's at 1.0, so you probably ask yourself "Robeco why aren't you at 1.1 or 1.2"? And I think we have to be careful here because we are seeing our flows and we are not seeing the outflows, what you are seeing in the ETF market so we are not down 15% in the AUM terms but we have been seeing 400-500 million of outflows and if this stays you could expect a bit more. This is the reason why we keep our cash levels high and if we want to do anything we prefer derivatives than the cash market. So if the market overshoots even more, we would definitely increase to a higher beta level.

Slide number 26, I have to make a compliance statement over here because I give you some information which I'm not allowed to do but I'll do it anyway because of the market volatility. I am giving here some preliminary unofficial performance numbers and I sent this presentation on Friday, I can tell you that we are now up 150 bps relative gross fees and the returns are indeed around -8%. If you look in Bloomberg, and I think that's important to highlight here as well, you see lower numbers. You see lower total return numbers because we have been making some fair value corrections. And why have we been doing that? If you look at benchmark pricing, still it's not really reflecting the state of the credit market. And if you track the cash indexes versus the ETFs but also the CDS indexes, there is a huge gap that can go from -1% to -2%, so we have been making those corrections to the NAV. Why do we do that? We do that to protect current investors. You can imagine that if you want to redeem your bonds at an NAV, which is incorrect, which is basically too high that it is not in the best interest of our remaining shareholders. We see this as an artificial underperformance or we're now back to benchmark levels. In due time, when the market corrects you do see that outperformance comes back again but that's the statement I have to make for value corrections which is market practice but it's just something you could see in the Bloomberg figures which are not aligned to the numbers seen on this slide. That's one note here.

Q&A.