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Diversify and forget Jackson Hole, Tobam tells global HY investors

High yield bond portfolios have been left dangerously undiversified under central bank policies, meaning investors have little margin for error, French investor Tobam warned this week, ahead of the Jackson Hole meetings in Wyoming.

By Victor Jimenez 24 Aug 2017

Corporate high yield bond buyers and participants in most capital markets, will pay close attention to the words of European Central Bank president Mario Draghi and Federal Reserve chair Janet Yellen at the meetings.

Draghi and Yellen are among many central bankers and finance ministers attending the three day economic symposium that the Federal Reserve Bank of Kansas City has organised each year since 1978.

Their monetary policies, and bond buying, are behind the all-time high levels of bond holding concentration and spread tightening in the global high yield markets, said Raphaël Thuin, Tobam's head of fixed income.

But paying too much attention to central bankers would be a recipe for problems, in his view. "We shouldn't expect any shocking decisions," he told *GlobalCapital*. "We'll probably know about the ECB's change of monetary policy and QE measures gradually, but again, it's difficult to work out what's in Draghi's mind.

"We have seen what happens when high yield investors try to guess, and demand piles up over bonds with short maturities, then goes in the opposite direction. It makes for a very nervous market."

In March, European high yield funds were hit with outflows of €1.4bn, according to JP Morgan. But the flows into short duration funds turned consistently positive with more than €160m of net inflows.

The duration trend reversed completely in June, as investors bought a €635m bond from Liberty Global's UPC Holding, with a coupon of below 4% for a 12 year bond, the longest maturity for a new deal in the European high yield market so far this year. Two other deals that month had maturities of 10 and 12 years.

Thuin said Tobam's latest data on what it calls the "diversification ratio" went some way to explaining these swings. This ratio is a measure of concentration in certain sectors and durations in fixed income debt portfolios.

In terms of sector concentration, Thuin said energy credits were the most overcrowded area.

"It’s striking, he said. "It is the elephant in the room for passive funds. Clients of those passive funds that track the benchmark index don’t realise the composition of the product they buy into. Of course, there’s a reason for this: this concentration has enjoyed a powerful rally. But what’s worrying is that there’s little room for growth here, and on the other hand, the chances of a high cliff can never be dismissed.”

The energy rally “is surprising”, in his opinion, because oil prices are still more than 50% off their 2014 highs, and borrowers are still “burning cash”. Global high yield bond issuers have a default rate of above 15% so far this year.

Masters of the HY Universe

“Bond buyers have as many reasons as equity investors to be concerned about the staggering levels of concentration in their portfolios,” he said. “But they aren’t, and that is particularly true for high yield bond investors at large. Whatever way you look at it, concentration stokes trouble for the wider market, so we think it’s worth it to open this debate, even if you are a small player.”

According to Tobam research, as few as 20 fund managers hold up to 45% of the stock of global high yield bonds.

“Those guys can call the shots,” said Thuin. “Unless you know what their plans are, you are in for a rough ride. They move in ways that are unexpected sometimes, affecting names that have little to do with the weaknesses observed in certain sectors at certain times. When they cannot sell bond holdings under temporary stress, but they start selling everything else."