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Annual Report & Directory Of Fixed Income Managers Canadian High Yield Hedge Investing

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As Canadian **pension** fund managers look for new ways to ensure their assets meet their liabilities, exploring areas such as liability driven **investment**, interest in fixed income products is growing.

And, with the shortage of supply of these products in Canada, **pension** funds are looking not only at new strategies, but outside the borders of Canada.

This marks **Benefits and Pensions Monitor** 2nd Annual Report and Directory of **Fixed Income Managers**.

In this year's report, Laurence Cashin and Barry Allan, of Marret Asset Management which sub-advises on Core Plus mandates for Greystone Managed Investments, examine Canadian high yield hedge investing.

Canadian corporations that need term financing and have non-investment grade credit ratings must issue U.S.-dollar denominated debt in the U.S. high yield market – with very few exceptions. Canadian high yield debt is underwritten in the U.S. because the buyers are American. More than 85 per cent of the high yield debt issued by Canadian companies is held in American institutional and mutual fund portfolios. The U.S. high yield market exceeds US\$1 trillion with roughly \$40 billion from Canadian issuers.

Canada is a country without a mature domestic non-investment grade corporate debt market and structural inefficiencies create opportunity for hedge strategies. For example, a portfolio holding capital structure arbitrage trades on Canadian high yield issuers can deliver excess returns with less volatility than 10-year Treasuries. A brief review of the asset class is needed before outlining alternative strategies in Canadian high yield. For simplicity, no distinction is made between leveraged loans and bonds. An introduction to the distressed debt asset class and contingent claims analysis is also needed.

The High Yield Asset Class

To be considered unique, an asset class must have a significantly different risk/return profile and a correlation with other asset classes below 0.8. Noninvestment grade debt meets this definition. For the 25-year period 1982 to 2006, the correlation with Treasuries is 0.20 and the correlation with investment grade debt is 0.50. For the period 2000 to 2006, non-investment grade debt's correlation with Treasuries is negative.

The creditworthiness of corporations varies and quality differences are reflected in relative bond yields and in the credit ratings issued by private agencies such as Standard and Poor's Ratings Services and Moody's Investors Services. S&P ratings notch downward from AAA to C. As shown in Table 1, BBB- and higher is investment grade (or high grade) and BB+ and lower is non-investment grade (also known as high yield or, pejoratively, junk). Multiple issues from the same issuer can have different ratings. For example, secured notes will have a higher rating than unsecured. Related issuers within a corporate structure can also have different ratings. For example, an operating subsidiary closer to the cash flow may issue senior investment grade notes and the parent holding company may issue subordinate non-investment grade debt. It is a fair comment that there is some subjectivity in agency credit ratings, that ratings often lag the market, and that no consistent mathematical relationship between the ratings categories exists.

Table 2 disaggregates the components of total return on a simplified basis. High yield total returns have a treasury-return component. However, high yield bonds have substantial coupons and low duration and are less sensitive to interest rate moves than Treasuries.

The return of the asset class is more dependent on the credit spread – the yield differential between high yield bonds and Treasuries. The credit spread is the reward for the credit risks that are borne – the risk of credit deterioration and the risk of default. The larger part of the yield premium compensates for the expected loss from future defaults and the balance is the credit risk premium. Credit spreads also contain a liquidity premium to compensate investors for lower liquidity in the corporate bond market (corporate bonds trade less frequently than highly liquid Treasuries) and friction costs such as bid-ask spreads.

The opening credit spread is the expected excess return over 10-year Treasuries for the holding period. Any subsequent narrowing of credit spreads due to positive macroeconomic conditions adds to the return of high yield portfolios, and any widening of credit spreads due to worsening economic conditions reduces return. Balance sheet leverage makes high yield bond issuers quite sensitive

to sharp changes in economic conditions. High yield credit spreads widen dramatically during recessions and narrow quickly during economic expansions.

The 10-year U.S. Treasury note is generally used to compute credit spreads because high yield bonds are issued with a 10-year maturity – albeit usually with only five years of call protection. Given that Canadian issuer high yield bonds are U.S.-dollar denominated, their credit spreads are also computed as a spread over U.S. Treasury notes. The spread of the Merrill Lynch Master II High Yield Index on March 31 was 285 basis points. Chart 1 depicts historical credit spreads.

High grade and high yield bonds can experience default if the issuer encounters financial distress. However, defaults on investment grade bonds are rare. High yield is more exposed to credit deterioration and default because high yield issuers have more financial leverage on their balance sheets and debt servicing consumes a larger portion of cash flow. The average annual issuer default rate was 3.5 per cent in the 25-year period 1982 to 2006. The trailing 12-month default rate at March 30 was 1.6 per cent.

The annual total return of the benchmark U.S. high yield index for the past quarter century ranged from 39.2 per cent in 1991 to -5.1 per cent in 2000, the worst year in history. The 25-year period had only four negative years. Table 3 gives the four best and four worst returns in the period, highlighting the attractive risk/reward profile.

Distressed Debt And Contingent Claims Analysis

Distressed debt is also a separate asset class. A brief introduction is helpful for illuminating the relative position of debt and equity investors' contingent claims on a company's assets in bankruptcy.

As mentioned, the current trailing 12-month default rate is 1.6 per cent. Dependent on a manager's credit selection skill, a widely diversified high yield portfolio will experience defaults. A manager may hold defaulted debt in the portfolio through the restructuring process, or sell to distressed debt investors. Distressed debt investors specifically invest in defaulted debt. They also invest in debt trading at very wide spreads and low dollar prices that indicate a high market expectation of default. Distressed debt investors sometimes buy the equity of defaulting companies. Distressed debt investors generate returns in the recapitalization process, when the defaulted debt is exchanged for new debt or new equity in the recapitalized company. It is a highly legalistic process and distressed investors often take control of the company.

When a debt issue defaults, it does not trade down to zero. In an efficient market, defaulted debt will trade down to the expected recovery value. The historical average recovery rate of defaulted debt for the period 1982 to 2006 is 36 per cent, according to Moody's.

The ratings agency defines the recovery rate as the trading price of the bond 30 days after the default event. An average 3.5 per cent default rate and a 38 per cent recovery rate computes to an average 2.6 per cent loss from defaults over the past 25 years.

The equity securities of defaulting issuers usually do trade down to zero – though frequently not until the day the equity is delisted by its stock exchange. The trading price prior to delisting is nothing but option value. In a corporate restructuring, lenders' claims must be satisfied before the owners of the company receive any proceeds. The rule of absolute priority in bankruptcy states that the most senior claim must be settled in full before any assets are applied against the next most senior claim – all the way down the ladder to the common equity at the bottom. Regardless of rating or subordination, any debt securities in the capital structure rank ahead of all equity securities in terms of contingent claims on the issuer's assets. Occasionally lenders consent to a restructuring that leaves some residual value for equity holders.

High Yield Hedge: The Canada Advantage

Structural inefficiencies in the Canadian high yield market include:

- Canada is a country without a developed domestic high yield market.
- Canadian corporations with non-investment grade ratings issue debt in the U.S. market underwritten by U.S. dealers, and issue equity in the Canadian market underwritten by Canadian dealers.
- Canadian companies often issue high yield debt at a spread premium to their inherent credit profile because they are foreign issuers in the U.S.
- The debt trades in the U.S. and the equity trades in Canada.
- The conclusions of credit analysts in the U.S. and equity analysts in Canada regarding the appropriate valuation for the company often diverge.
- The two markets often react differently to the same news event and price movements can diverge dramatically.
- Research shows that the return to the holders of debt issued by leveraged Canadian companies exceeds the return to equity holders.

For funds able to take advantage of alternative strategies, the inefficient Canadian high yield market offers an opportunity to reduce volatility and enhance returns. Marret Asset Management Inc., for example, employs three main strategies in its alternative high yield funds: capital structure arbitrage, directional trading of credit spreads through the three phases of the credit cycle, and opportunistic trades. The broader mandate is to go long or short any part of the capital structure of a Canadian high yield issuer, a leveraged buyout target, a ratings downgrade candidate, or an Income Trust. Capital structure trade ideas are discovered through fundamental bottom-up research. The strategy also employs sector and macro overlays. For example, during the latter stages of an upswing in capital expenditures in a sector, when borrowing increases, the short positions in this sector are increased.

A high yield capital structure arbitrage trade typically combines a long position in an issuer's debt securities (the senior part of the capital structure) with a short position in its equity securities (the junior, more risky part of the capital structure) using a hedge ratio. Optimal hedge ratios are calculated by regressing the historical trading prices of the debt and equity over multiple time periods. The price volatility of a typical issuer's equity is four times the price volatility of its debt securities. Therefore, the typical hedge ratio is 25 per cent – for every \$1,000 of debt held, the short position is \$250 of the common equity.

In the case of over-valued equity, a capital structure trade is characterized as long the inexpensive part of the company's capital structure and short the expensive part. There is only one set of cash flows and one group of assets supporting the capital structure or total enterprise value of any company. Using an enterprise value (EV) to earnings before interest, taxes and depreciation and amortization (EBITDA) valuation, where enterprise value is the total book or par value of a company's debt added to the market capitalization indicated by the current trading price of the issuer's common stock, there may be too many 'turns' through the equity. For example, a four times leveraged company, as measured by debt-to-EBITDA, may have an EV-to-EBITDA multiple of 16 times, ascribing a value of 12 times EBITDA to the equity.

As well as cheap/rich trades, capital structure trades are also yield harvesting trades. The coupon on the debt security creates a positive carry and the short stock position hedges potential deterioration in the issuer's credit quality. The coupon and the hedge ratio also provide protection if the equity valuation gets richer. For example, assuming a typical hedge ratio of 25 per cent and an eight per cent yield on the debt leg, the equity price can increase 32 per cent and the trade is still a break-even proposition.

Other high yield hedge trades include:

- Pairs trades within the capital structure of two companies operating in the same industry – for example, long the cheaper forest products bond and short the expensive forest products bond.
- Unhedged high yield debt longs, particularly in Phase 1 of the credit cycle.
- Unhedged high yield debt shorts, particularly in Phase 3 of the credit cycle.
- Common equity trades – long the equity of high yield issuers with rapidly de-leveraging balance sheets and short the equity of high yield issuers with rapidly growing debt.
- Short the investment grade bonds of leveraged buy-out candidates with no change of control covenant protection.
- Income Trust trades.

A basket of these trades and capital structure trades that are dynamically hedged (actively adjusting the hedge ratio for price movements in the debt and equity securities in each trade) has a very attractive risk-reward profile which should appeal to Canadian pension funds seeking fixed income substitutes with higher returns and lower volatility than traditional fixed income products. ■

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