The Thirst For Yield (and other Class A drugs)

The past decade has seen the emergence of the yield junkie. You recognize them from their propensity to pay and subsequently overpay for anything with the tiniest shred of yield from investment grade corporate bonds to sovereign bonds to AAA rated junk. In the past couple of years, the yield junkie has trampled on spreads and thinned out yields across investment grade and high yield bonds. The more hardened ones even buy equities for an at risk dividend payout.
There are various sources of yield. There is duration risk, which tends to be isolated in the sovereign debt of a handful of countries who remain solvent enough to repay their debts or have a sufficiently strong following that they can continually issue their payment-in-kinds until, well, until they cannot. There is credit risk, which is the element of risk over and above the risk free asset of similar duration or tenure, although the concept of a risk free asset is a bit threadbare at the moment, but let’s suspend disbelief for a moment. And why not, the central banks have suspended theirs indefinitely. Another source of yield, and now we are in the realm of Class A drugs, is option premium. Side effects include a healthy dose of negative gamma and often an even healthier dose of built in leverage. Dealers of course would suggest the application of light leverage, only because the application of heavy leverage looks too much like a lit fuse. A mercury switch is much more marketable.

As so often happens, dealers become users when they sample their own wares. Its when management samples the inventory that the wheels really threaten to come off. The largest buyers of US treasuries are private commercial banks and the Fed. The continued debt monetization operations of the central banks flatten yield curves and compress yields leading to mark to market profits for current investors. But what can investors today expect in future returns? The same question is relevant not only of treasuries but also of investment grade and even high yield corporates.

Lets try to find the new drug of choice for the yield junkie before they really get deep in it. What are the prospects for high yield? Average high yield spreads in the last 20 years have been around 590 bps. In the financial crisis, they spiked to over

1800 bps. Today, high yield has recovered to a fairly tight 615 spread to worst. How about leveraged loans? Leveraged Loans have typically traded 140 bps tight of high yield. In the financial crisis, leveraged loans traded in line with high yield, a significant underperformance. Since then they have recovered with equal abandon. However, since the financial crisis, leveraged loans now trade within 50 bps of high yield. Why is this?

The reason lies not in the properties of the asset but the nature of their buyers. The main buyers of high yield are mutual funds. (If ever there was a proxy yield junkie, the long only, index hugging mutual fund is it.) Insurance companies, bank prop desks and hedge funds used to also participate but with increased regulation (read Basel 3 and Solvency 2 which are basically trying to wean the junkie off the poison by allowing them only controlled doses supported by…. Capital), demand is a lot less frantic than before. And besides, hedge funds tend to be long and short the stuff, equally imbibing and dealing at the same time. Leveraged loans, however, were the preserve of the structured credit animal called the CLO, a specific flavour of CDO. CLO issuance has ebbed since 2008, globally, but especially acutely in Europe. As a result leverage loans are relatively unloved. Also, because of the unfortunate nomenclature of credit markets, these senior secured debt instruments have been unloved by the garden variety investor (this includes institutional investors, it's a big garden.)

Since central banks have fiddled with sovereign balance sheets, banking system balance sheets and real economy relative prices, they have created a situation where interest rates are expected to remain low for the foreseeable and indeed unforeseeable future. Until inflation perks up, or a recovery takes hold, or someone describes the Emperor's new clothes.

Corporate bonds, investment grade:

- Fixed rate.
- Tight as a drum.
- Implying low default rates.
- Senior unsecured.

Corporate bonds, high yield:

- Non investment grade issuers

- Senior unsecured
- Elements of equity risk
- Fixed rate
- Average spread of 615 bps

Loans:

- Non investment grade issuers
- Senior secured – senior in claim to second lien and to senior unsecured (bonds)
- Floating rate.
- Average spread of 580 bps.

Loans are no panacea in an over QE’d world, but hopefully, given that garden variety investors will take some time to react to this asset class, yields should not collapse. Also, there is a relative value argument that is pretty compelling. With average recovery rates of 40% for high yield and 80% for loans, and average spreads of 6.1% for high yield and 5.8% for senior loans, conceptually at least, one could buy a dollar of loans and 60 cents of credit protection netting a yield of 2.14% with a loss given default of 16 cents. It is highly highly highly unlikely that you will be able to perform this little trick within the same issuer, that would be too easy. However, the arithmetic highlights the relative value opportunity between high yield and senior loans.

The above analysis is a stretch for the yield junkie but here is something they might understand. When a government is as indebted as the Western governments are, interest rates cannot remain low for long. Fixed rate bad, floating rate good. Unsecured bad, secured good. Subordinated bad, senior good.

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What are the chances that strategies like this will be offered in a regulated, risk managed, transparent, fund format to investors? Professional gatekeepers and experts stand in the way, and unfortunately the industry contains professionals who may lack the intellectual faculties or experience to understand strategies or matters in general outside a very tightly defined remit. Fear of the unknown, superstition, insularity, and reckless extrapolation plague certain parts of the industry. These elements limit the scope of investment opportunities to the general public to the detriment of all.