High yield bonds: a mature approach

Fixed income | June 2019

Roman Gaiser
Head of Portfolio Management, High Yield, EMEA

The Threadneedle European Short-term High Yield Bond strategy focuses on maturity over duration to manage risk, which should mean lower interest rate sensitivity and less unpredictability.

High yield bonds can offer a superior yield to investment grade credit and sovereign bonds such as German bunds and gilts – something that has made them popular in today’s low interest rate environment.

A majority of high yield bonds are “callable”. This means that at predetermined points in time, before they ultimately mature, the issuer can “call” back the bond, repaying the bondholders, typically at a premium. For example, a bond with a maturity of 10 years might be callable after five years. The duration of such a bond is priced to the call date if there is an expectation that the bond will be called, at that period in time.

But if interest rates are rising and the bond price falls below its call price, then the issuer may choose not to call the bond. In practice, this can lead to an extension of the bond’s duration or interest rate sensitivity just at the wrong time – in a falling bond market, where yields are rising. As a result, the fall in the bond’s price can accelerate.

For this reason, we focus on a bond’s maturity rather than duration when managing risk in the Threadneedle European Short-term High Yield Bond strategy. This removes the unpredictability of duration extension risk, giving this strategy lower interest rate sensitivity than a standard European high yield bond strategy.

Explaining duration extension risk
Callable (or redeemable) bonds give the issuer the right to redeem the bond prior to its scheduled maturity date, effectively shortening the bond’s expected maturity and duration. These bonds benefit issuers in that they give them the option to pay off the debt early and refinance at lower costs if interest rates fall.
So when bond yields are rising, the call dates on callable bonds become less likely to be triggered. In such a scenario, investors who thought they had a bond due to be redeemed at the call date in three years can, for example, suddenly find they are holding a bond that will likely remain in existence until maturity in five years with a corresponding impact on the bond’s price.

Take Ardagh Packaging, the Irish subsidiary of a US containers and packaging company, with callable bonds maturing in 2024 and an initial call date of March 2020 (Figure 1). While the bonds have just under five years until they reach maturity, the bond’s current price is above the call price for March 2020 – which could indicate the bond will get called. It is for this reason that the market effectively prices these bonds as one-year risk.

But should these bonds become less likely to be called (eg, during a wider market sell off or if there are credit issues), then the duration (or interest rate sensitivity) could increase to that of a five-year bond. As the bond price falls past its call price – €101.375, in the case of Ardagh Packaging’s March 2020 call – then the market focuses on either the next call date or the final maturity date. Duration is extended and the price fall accelerates.

Figure 1: Ardagh Packaging call dates and prices

<table>
<thead>
<tr>
<th>Call dates</th>
<th>Call price</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-Mar-20</td>
<td>€101.375</td>
</tr>
<tr>
<td>15-Mar-21</td>
<td>€100.688</td>
</tr>
<tr>
<td>15-Mar-22</td>
<td>€100.00</td>
</tr>
<tr>
<td>15-Mar-24</td>
<td>€100.00</td>
</tr>
</tbody>
</table>


In a market sell off, therefore, a callable bond can lead to a duration extension just when you least want it. For us, focusing on the bond’s maturity date (and not the call date) from the outset makes our strategy’s desired risk and performance profile more predictable.

Avoiding unexpected volatility

A low-yielding environment should make investors more sensitive to volatility. Instead, investors are often lulled into a false sense of security, making little distinction between short duration and short maturity. It is only when volatility suddenly picks up with a bond market sell off – causing a callable bond’s duration to sharply extend – that the difference is fully comprehended. By then, it is too late.

High yield may still offer an attractive source of return in today’s low-yield environment. But we believe that targeting callable bond maturity rather than duration is the best way to harvest this yield – yet avoid any unexpected volatility and yield curve risk.