Global Fixed Income

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High yield offering high coupons *and* high quality

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Lower-than-expected US inflation data last week prompted a rally in bond markets which drove yields lower. This is the seventh such rally in the last 18 months or so as investors search for signs of an end to interest rate hikes and the proximity of interest rate cuts.

However, for high yield investors we think its important to remember that it is not necessary to call a turning point in markets in order to make good investment returns. What we view as more relevant to sustained returns in the high yield market is the good quality new issuance in recent weeks. The slightly better inflation data should catalyse further such issuance in the near term.

For example, Ineos Styrolution issued secured bonds with an 8.5% coupon. This base chemical company is of course cyclical, but the issuance helps improve its credit profile so that the majority of debt doesn't mature until after 2026. The bond has been designed with a package of protections for its holders that allows credit rating agencies to give it a BB rating – the higher quality end of the high yield world.

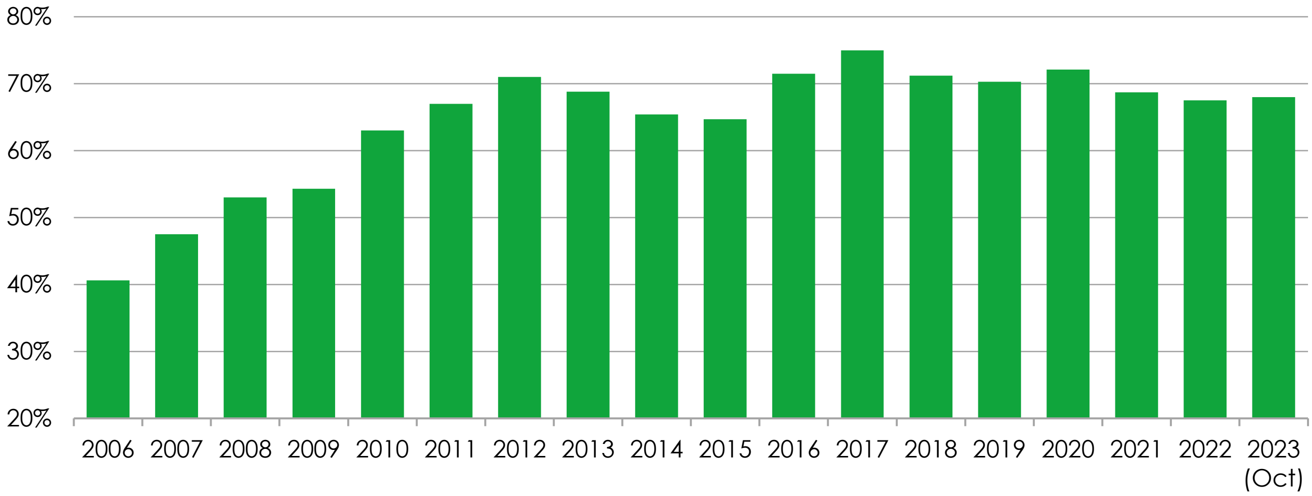
Another BB issue comes from French recycling company Paprec. Some of the glow on its Tricolore halo has been dimmed by recent controversies related to its founder, but we see value in its six-year secured, BB-rated euro bonds at 7.5% which have allowed it to refinance near-term debt, with the next bond maturity not due until 2027.

Discount store owner, B&M, a highly successful retail story in a world of closing bricks and mortar shops, this week issued BB+ bonds with an 8.125% coupon. Meanwhile, Barclays recently announced a USD additional tier-1 (AT1) bond with initial price talk at 10.5%. It wasn't long ago banks were issuing AT1 bonds with coupons below 5%.

Past performance does not predict future

The high yield market has evolved in recent years towards higher-quality bonds, as shown by the chart below of BB issuers as a proportion of the market:

% of BB in European High Yield bond market

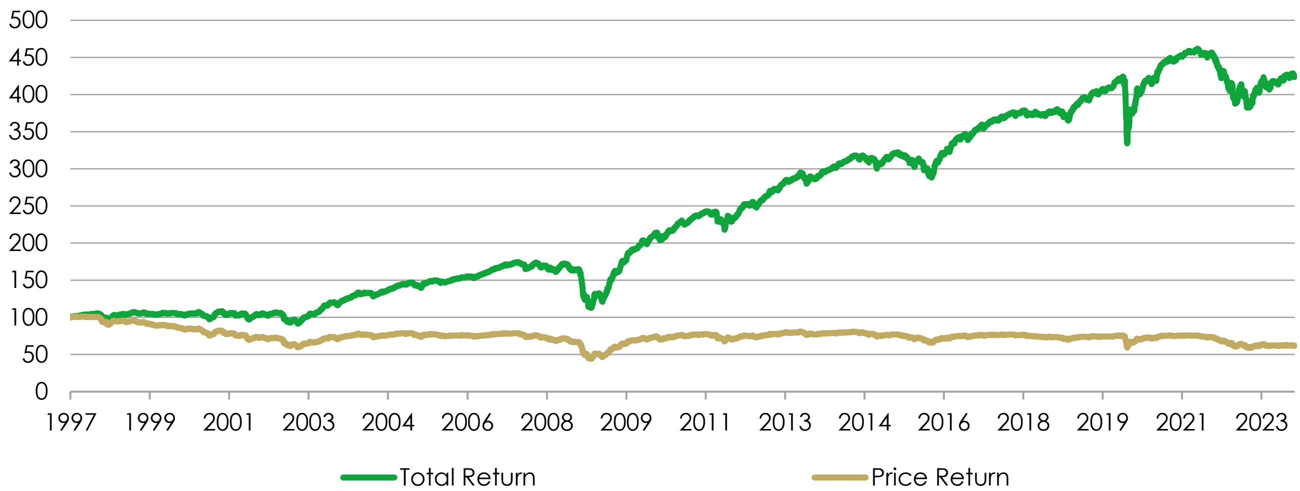


Source: Bloomberg, ICE BAML, Liontrust

We have consistently highlighted the 'evergreen' nature of high yield bonds. While periods of market volatility will lead to times when bond prices trade at a in profit or loss relative to purchase price – a concept known as the 'marked-to-market' return – these fluctuations can be set aside if bonds are held for the medium to long term, allowing the coupons to take centre stage. It is these coupons that ultimately drive returns in the high yield market.

If held to maturity, the price return from high yield bonds as a group will be marginally negative due to the impact of a small number of issuers defaulting. Not only can this negative price impact be alleviated by selecting high-quality issuers less likely to default, it is also massively outweighed in the long term by the large positive returns from coupon income. The chart below shows the difference between the ICE BofA Global High Yield Index's moderately negative long-term price return and its impressively positive total return - a difference which is accounted for by income.

ICE BofA Global High Yield Index Total Return versus Price Return



Source: Bloomberg, ICE BAML, Liontrust.

The current average coupon in the high yield market is 4.2%, but we think it's only going in one direction and will sustain decent, quality return from high yield bonds in the years to come.

Past performance does not predict future

The 9% yield on the Liontrust GF High Yield Fund, in our view, guides us very well on the future return outlook on the asset class.

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.

Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;

The creditworthiness of a bond issuer may also affect that bond's value. Low rated (high yield) or equivalent unrated debt securities of the type in which the Fund will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.

The Fund can invest in derivatives. Derivatives are used to protect against currency, credit or interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions.

The Fund uses derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

The Fund invests in emerging markets which carries a higher risk than investment in more developed countries. This may result in higher volatility and larger drops in the value of the fund over the short term.

The Fund may encounter liquidity constraints from time to time. Participation rates on advertised volumes could fall reflecting the less liquid nature of the current market conditions.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Disclaimer