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Junk bonds' risk-return profile has been permanently damaged

Upside potential hit by call protection erosion and a drop-off in recovery rates

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"The past is always triple-A. We can all remember what the past was. But if we try to make the future triple-A, we have no future. The future is always single-B."

Michael Milken, the "junk bond king", was not describing the asset class he created, but he could well have been. In hindsight, high-yield bonds have been one of the best performing asset classes on a risk-adjusted basis of any in the world, an asset class delivering equity-like rewards with half the volatility.

Like all things too good to last, capital markets have come to chew the fat off this remarkable record. The past 10 years of nibbling by banks on behalf of issuers, left unchecked by a slow, overly concentrated and largely inefficient asset management community, has left the risk-return on offer in the future some way behind what has been achieved since Milken's heyday.

It is ironic that an asset class that has taken decades to rid itself of the unflattering "junk" tag now finds itself in a state more likely to exhibit junk status than ever before.

The path of a high-yield bond used to be simple. Companies usually issued high yield debt at a time coinciding with their own stress — financial, operational, or both — meaning that their creditworthiness was likely to go one of two ways: either improve, or fail to improve and ultimately default. If the company was to grow successfully into its capital structure, enabling it to refinance at much lower rates of interest, or be acquired by a bigger fish, the bondholder would have been compensated royally by clauses limiting the company's ability to redeem these high-couponed bonds.

When the company's turnround did not work out, the magic of the asset class was that investments did not go to zero. Why? Because bondholders got the keys to the factory, the claim on the inventory, the assets. In fact, in some cases this recovery could amount to a substantial slice of what was lent out in the first place.

Now, upside potential has been curtailed by years of call protection erosion: the time before which the issuer can choose to refinance or redeem the outstanding notes. Call protection has halved in just five years, driven by banks, sponsors and companies holding the aces in negotiations of primary corporate issuance over a buyside handcuffed by the search for yield. The overly concentrated buyside has largely ignored capacity constraint warnings, and their narrow mandates have made them forced buyers of issuance on questionable terms.

As a result, companies can now readily exercise their option to call bonds back, capturing the upside that in previous cycles investors would have enjoyed via the bond's price as it remained outstanding, rising inversely to reflect the company's risk falling.

Meanwhile, downside potential has increased via a drop-off in recovery rates as companies benefit from ultra-weak covenant protection in documentation to leak assets out, prolonging life and optionality for shareholders at the cost of bondholders.

There should have been a meaningful default cycle early last year: the world was in the grip of significant deflationary forces, and the price of oil and other commodities had dropped precipitously. This left many companies, particularly those operating in the energy and basic industry sectors, close to the brink. What kept them from falling over was their ability to pledge their crown jewels in return for a liquidity boost.

Many of the companies that survived would not have done so in any previous cycle. Covenant protection of existing bonds would have precluded the pledging of assets that had already been pledged to junk bond owners. The companies ensured their survival in 2016, but in a future default scenario the recovery to the high yield bondholders will be severely restricted once the new secured lenders have had their piece.

Indeed, JPMorgan estimates that just 17 cents on the dollar have been extracted in recovery from recent defaults, the lowest ever level — and this at a time before default rates have picked up from their current near-historic lows. It is not unreasonable to assume this number will be even lower when a default cycle gathers speed.

The risk-return profile of high yield has been permanently damaged as a result of these factors.

The buyside should respond by reducing their reliance on primary markets, tapping fully into the opportunity set available, changing mandates to be fully global, accessing debt across capital structure and debt instruments. Only investors with a truly flexible and nimble approach will succeed going forward, with the passive community waiting to feast on the assets of those unable or unwilling to make the changes necessary to perform in an asset class without the fat of the past.

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