

## U.S. Still Dominates Global High-Yield Universe

*Greg Hopper, Manager of the Artio Global High Income Fund*

**Greg Hopper:** As the name suggests, our fund invests in high-income-producing, fixed-income instruments on a global basis. Unlike a number of high-income or high-yield funds that invest almost entirely in U.S. high-yield securities, we take a broader view of the market.

We diversify across a couple of different dimensions. One is geographic. So we will invest in, for example, European high yield, which has been both our bane and our boon over the last year and promises to continue to be. We will also invest in emerging-market corporates.

We will also diversify up and down the balance sheet, so we don't just buy bonds. We will buy loans. We will venture down into busted convertibles and even preferreds at times. And we will also diversify into what I call allied asset classes – meaning crossover or investment-grade securities – provided they offer us what we believe is the same kind of risk/reward that more traditional high-yield or high-income bonds provide. We will also invest in stressed securities, meaning securities that are actually in reorganization, either out of

bankruptcy or in bankruptcy.

Despite all the diversification efforts, though, the traditional U.S. high-yield bond-asset class is probably the biggest and most developed portion of what we consider to be the global high-income universe. It will be the bulk of our portfolio as well. But, unlike a number of other high-yield bond funds, ours is deliberately diversified away from that. We think that provides us advantages: It normally creates a more diversified portfolio that should be more efficient. That's what we're trying to accomplish.

**Forbes:** It's diversified not only by types of securities but geographically, as well? And by high risk as well as others that may be less risky?

**Hopper:** Right. We diversify geographically up and down the balance sheet and into neighboring asset classes that might not normally be considered high-income.

**Forbes:** Do you get into preferred stocks, at all? Or is it all fixed income?

**Hopper:** We do occasionally buy preferred stocks, as long as what we're buying has some underlying, first-loss equity piece, so that we're not the folks that get knocked down immediately. We'll

buy it.

So that is the broad lay of the land for the fund. It's an auspicious time to actually be talking about the asset class from the perspective of this fund because, along with all risk asset classes, high-yield or high-income had a tumultuous couple of months starting in August. As I speak, a lot of the downdraft that we experienced in August and September is seemingly at least reversing itself.

**Forbes:** With our interest rates very low and most of the world's lower than they have been, characteristically does that add some risk exposure to the high-yield securities?

**Hopper:** Much less so than to higher-quality securities. For example, the yield on the global high-yield index that we use as our benchmark as of October 26th was 8.75% or about 750 basis points more than comparable treasuries. So if interest rates were to start moving up, in all likelihood they would be moving up in response to a stronger economy.

In a stronger economy that spread of 750 basis points above treasuries is the return that you're getting for taking on the credit risk. That should actually be

going down, because your credit risk normally would be going down in an improving economy.

A security that we invest in – whose primary risk is credit – will tend not to go down nearly as much in a rising interest-rate environment as a pure Treasury or a very high quality corporate mortgage security. That's not to say that our asset class is completely immune to interest rates, but they are certainly cushioned.

**Forbes:** So you wouldn't expect them to go in the opposite direction if there is an increase in interest rates?

**Hopper:** It depends on a lot of factors. I'd hate to qualify it a lot, but it depends on how big an interest-rate move we're talking about, and on where you start out.

We're starting out at 750 basis of credit spread. That's a pretty big cushion to start out with. Historically, credit spreads have lived in the sort of 250 to 500 basis-point range. That goes back into the 1990s and the 1980s. It's a different market environment, I will grant you, but even more recently a reasonable range has been sort of 400 to 600 basis points.

So at 750 basis points you have a fair amount of cushion. The bigger risk with high yield, or high income as we prefer to call it, is not really interest-rate risk but the opposite – the risk of a deteriorating economy, the risk of financial turmoil, sovereign default, etc.

In fact, we would argue that investors historically are too nervous about the risk in high yield. Because if you look at that high yield spread, for example, now at 750 basis points, that is enough excess spread to pay for a very substantial default rate – default rates that would be more typically associated with a deep and long recession.

And the reason why we're at those spreads is because investors did sell off

so nervously in August and September. They sold the equity market off, as well. But I would argue they didn't sell it off as much as high yield, because I believe that the P/E ratio got down to maybe 12. To me, 12 does not sound like a P/E ratio one would be paying for if one were truly concerned about a recessionary kind of environment. But 750 basis points of credit spread, that is a recessionary kind of credit spread.

**Forbes:** I see. Can you get into some specific areas that you either like or don't like?

**Hopper:** First of all, we'd like to validate our top-down thesis with bottom-up specific examples. That's part of our process. We think high yield is cheap. But can we find real examples when we look among individual issuers? The answer is yes.

One example is a specialty chemical producer whose products are sold to a variety of different industries. So unlike a more commodity-like chemical producer that tends to sell just into the packaging space or something like that, it sells into a number of different industries.

It has been generating cash flow, what we define as basic, free cash flow, which is basically your EBITDA less interest expense, less capital expenditures of about 10% of their debt structure, which is more like a BB kind of ratio. Although their company rating is B, the bonds that we actually invest in, they are actually CCC because we invest in the more subordinated part of the structure, since we think it is an improving situation.

The other thing we like to do is not only crunch the ratios but actually see what's really happening with the company. So 10% of total debt is basic, free cash flow. What are they actually doing with the cash flow? Well, we discovered that they are using at least some of it to

pay down senior debt. So here's a company, well-positioned in its industry, generating cash flow even in this environment and using it to pay down debt. Yet we've been able to purchase it at double-digit yields.

That's what I would say is a validation thesis.

**Forbes:** The chemical producer is a U.S. company?

**Hopper:** Yes, it is.

In addition, by the nature of how we approach the market we are inevitably involved in European high yields. So we probably either benefit or suffer from that more than others. Lately it's been suffer. Although we've had slightly less European high yield than our index, we've had more than our competitors.

The reason we've had less than the index is because we have been a little bit cautious around the issue of sovereign debt and possible financial meltdown in Europe. That is starting to clear – although I don't think we're out of the woods yet.

As it does clear, we become more positive on European high yield. Because it has been such a difficult period for that part of the world, there are a lot of issuers there that have really been sold down. Even though, on average, the credit metrics among European high-yield issuers are better than U.S. high-yield issuers and the ratings on average are better, the spreads are substantially higher than the U.S. So we're looking to pick up individual issues there.

**Forbes:** Any particular countries that you aim for or aim away from?

**Hopper:** We're trying to first look in what I call neighboring Europe or near-by neighbors. That would be the U.K. and Ireland on one side, Eastern Europe on another. Then secondly, the northern tier of Europe such as Germany and

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the Scandinavian countries. Only after that, selective companies or babies that have been thrown out with the bath water in the southern tier.

It's a little bit like separating spaghetti from sauce here because every company inevitably is involved in every country. And that goes beyond Europe, which is part of the thesis here. You

have companies that might be based in Europe, but just like companies based in U.S., a substantial part of their sales and even production can be outside Europe. Yet, because they're European issuers, they get painted with a Euro brush.

And there we are seeing yields that are habitually in the double digits for every-

thing from cyclically-oriented companies to somewhat cyclical packaging type companies to health care companies.

**Forbes:** Very interesting. And very different than what we usually cover. I much appreciate your taking the time to share your thoughts with us, Greg.

**Hopper:** Thank you, Wally. **F**

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