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High-Yield Investing In A Rising Rate Environment

MAY 2, 2022 • RUSS ALAN PRINCE

DAVID BREAZZANO CO-FOUNDED POLEN Capital Credit in 1996 and has more than 41 years of experience in high yield, distressed, and special situations investing. At Polen Capital Credit, he oversees the investment team and chairs the Investment Review Committee. Mr. Breazzano also sits on the Operating Committee of Polen Capital Management (the parent company of Polen Capital Credit).

Russ Alan Prince: Can you tell us more about Polen Capital Credit and where are you finding income in the current environment?

David Breazzano: Polen Capital Credit, formerly known as DDJ Capital Management, is a firm that I founded in 1996 for the purpose of investing in the high yield bond and leveraged loan markets, or what is today collectively referred to as the leveraged credit market. Prior to founding the firm, I served as a high yield portfolio manager at both Fidelity and T. Rowe Price. While there, I observed certain inefficiencies in the leveraged credit market that larger investors did not exploit.

For over 25 years, Polen Capital Credit has applied the same rigorous, bottom-up fundamental, and legal analysis to uncover attractive investment opportunities for our client portfolios in what our experience has shown to be the most inefficient area of the high yield market, namely, the lower-tier segment.

At Polen Credit, we construct concentrated portfolios, position-by-position, to provide a yield, or income, advantage compared to that offered by the broader leveraged credit market. In doing so, we are seeking to identify quality businesses that can produce a steady stream of cash flow to service their debt obligations. Once we identify an investment with these characteristics, we tend to buy-and-hold, building fewer, but larger, positions as compared to our competitors. The outcome for our clients is a portfolio that benefits from the compounding effect of the income generated by these holdings over the long term.

One of the key differentiators of our investment strategies is the flexibility to invest across asset classes within the leveraged credit market. This flexibility has proven to be invaluable to the success of our strategies and is serving our clients well in the current environment.

Today, several "macro" factors, such as inflation and rising interest rates—to say nothing of the dire situation in Ukraine—have resulted in considerable volatility within the leveraged credit market. This volatility has created an opportunity to add to existing positions, as well as to selectively initiate new investments in both high yield bonds and leveraged loans.

Prince: How can high yield investing be a good idea in a rising rate environment?

Breazzano: Given that credit spreads, or the premium earned for accepting credit risk, typically decline when rates rise, high yield bonds have traditionally provided a hedge against a rise in interest rates through spread tightening. In addition, these bonds generally have a shorter maturity and a higher coupon than investment-grade bonds and, therefore, a much shorter average duration. As a result, high yield bonds have performed well in rising rate environments. However, not all high yield bonds are created equal, and a deeper look at the market reveals that some bonds perform better than others.

High yield market data demonstrates that the lower tier, specifically CCC-rated bonds, can offer a considerable hedge against rising rates relative to their higher-rated peers. Rising rates typically reflect improved economic conditions, in particular benefitting the creditworthiness of CCC-rated issuers, which oftentimes are the most credit-sensitive within the high yield market. On the other hand, BB-rated bonds, which do not offer the same credit risk premium as CCC-rated bonds, tend to be more interest-rate sensitive as a result of their higher quality, as they are "almost" investment grade in creditworthiness. As a result, their spreads tend not to tighten as much, and thus do not offset the rise in rates, to the same degree as their lower-rated peers.

However, the CCC-rated segment of the high yield market requires careful analysis of each individual credit to avoid

the historical default losses that this cohort experiences most typically at the end of the credit cycle. Therefore, given Polen Credit's expertise and experience in finding higher yielding opportunities in the CCC-rated segment of the high yield market, we believe that we can provide our clients with an additional benefit in the form of a natural interest rate hedge. Importantly, this natural hedge benefits our client's overall fixed income allocation without exposing the client to undue levels of credit risk.

Prince: While both high yield bonds and senior bank loans are attractive for their relatively higher yield-generating qualities, which is more compelling today?

Breazzano: As I mentioned earlier, the flexibility to invest in both high yield bonds and leveraged loans within our client portfolios is a key differentiator for our investment strategies. Our research process is designed to identify the best risk-reward opportunities regardless of whether they come to market in the form of a high yield bond paying a fixed coupon or a leveraged loan that makes floating coupon payments that reset higher, or lower, along with prevailing rates.

However, we are not making asset allocation decisions in the portfolio based on the relative value between the broad high yield bond and leveraged loan markets. Rather, we use the flexibility provided by our clients to identify the most attractive investments on a position-by-position basis. Ultimately, our client portfolios benefit from our ability to allocate between bonds and loans based on their relative attractiveness, enabling us to add value to our clients based on changing market opportunities throughout a credit cycle.

With that in mind, the sell-off to begin the year was at first driven by fears of inflation and rising rates. These fears placed a disproportionate burden on the highest quality segment of the high yield market, which, as I noted earlier, tends to be more sensitive to rate increases. Conversely, leveraged loans, for reasons described earlier, have much less interest rate sensitivity and fared better.

As the devastating war in Ukraine has unfolded, concerns about its impact on global growth and supply chains, together with heightened geopolitical uncertainty have resulted in a broader "risk-off" mentality that has finally seeped into the leveraged loan market, albeit to a much lesser extent. During this time, we have reduced our allocation to certain leveraged loan positions and correspondingly added higher yielding bonds to our portfolios. We are making these investments in businesses that our research shows are stable, well-positioned to withstand the current market uncertainty and offer very attractive yields. Through these actions, we remain committed, as Polen Capital's fourth, and newest, investment franchise, to achieve the firm's mission to preserve and grow client assets to protect their present and enable their future.

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