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Global High Yield Whitepaper

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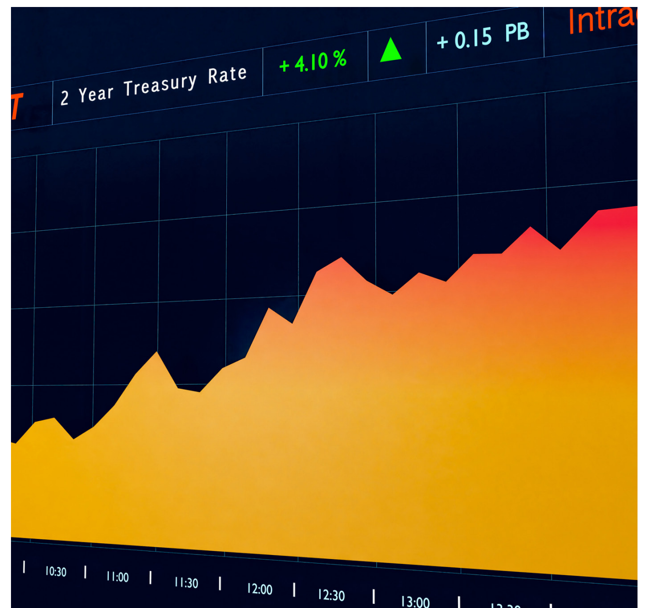

Contents

03 Introduction

04 Global High Yield Roundtable

10 Roundtable Participants

15 Artemis: Global High Yield – balancing the opportunities with the risks

20 Barings: Three Reasons Why the Fixed Income Environment May Be Better Than You Think

Welcome to CAMRADATA's Global High Yield Whitepaper

In an economic environment rocked by inflation, war and the overspill of a pandemic, there is often little appetite for risk.

Flows out of high yield funds over the past year, according to Lipper, have shown investors' caution towards the asset class, but the US Federal Reserve raising interest rates may have done it a favour by constraining supply.[1]

Yet expected default rates have been on the rise in recent months, according to rating agency Fitch. In April, it cited the collapse of Silicon Valley Bank as a catalyst for it raising its estimate to between 3-3.5% over 2023, up from the 2.5-3.% it predicted in October.[2]

However, these estimated defaults are lower than the agency's historical average of 3.6%, despite a backdrop of US political wranglings about its debt ceiling.

This may explain why spreads above fixed income instruments further down the risk curve are relatively narrow, despite the looming threat of recession in some major global economies.

But with an asset class that is buffeted more than most in the field of fixed income by external factors, how should investors be assessing it within a portfolio?

[1] https://lipperalpha.refinitiv.com/2023/04/high-yield-corporate-debt-funds-attract-inflows-as-high-yield-bond-issuance-increases/#

[2] https://www.fitchratings.com/research/corporate-finance/us-hy-default-rate-inches-higher-diamond-sports-default-looming-14-02-2023#:~:text=We%20forecast%20HY%20defaults%20will,out%20of%20the%20TTM%20period.

Meet the Team

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Managing Director, Client Relations

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Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Global High Yield Roundtable

The CAMRADATA Global High Yield Roundtable took place in London in May 2023

Navigating high-yield debt through economic storms

High-yield debt has felt the impact of global economic malaise and high inflation over the past year, though the returns available are piquing investors' interest once more.

Defaults may be on the rise, but countering that is the huge range of investment options available within the asset class. So, what is the outlook for high yield and, importantly given the economic slowdown, for recoveries from these securities? Which looks more attractive – sovereign or corporate high yield – and how does the pressing issue of sustainability play out in the space?

CAMRADATA invited a panel of senior investment specialists to weigh up the opportunities and challenges of this asset class. Panellists on the roundtable came from a wide range of backgrounds, serving both institutions and private clients in developed and emerging markets. From their divergent standpoints, they shared their contrasting client views about high yield's appeal.

Artemis' Fixed Income Portfolio Manager Jack Holmes was upbeat. "Definitely the conversations we've had recently are more positive on fixed income more broadly but within that high yield," he said. "We have clients that had stepped away from fixed income and been very low duration for the last decade [now] re-evaluating the space.

"A lot has come from investors re-evaluating equity exposure and still wanting to have some upside without the same level of downside. The other factor is that many investors have had to hunt for alternative sources of yield over the last five years and there is a bit of a relief switching from something like private credit or something more exotic, to something that's a bit easier to understand and to communicate to the end client."

Chris Sawyer, Head of the European High Yield Investments Group at Barings, noted, "What we've seen this year is people accept the world is different – it is likely to stay different. We're not a believer in rate cuts this year or in inflation being under control and a lot of investors are coming round to that. So, this high-yield, higher-for- longer environment is one we should all get used to.

"In credit generally there is a little bit of something for everybody. If your focus is on liability matching, you probably want to look more at high yield or investment grade – if you need income, you've got loans, which are currently offering a high single digit running/income yield given their floating rate nature and the move in base rates. Once you understand the credit risk in each market, there's some pretty good value to be had."

> ***"With our larger family clients, we're often the most liquid part of their strategy. That's something we're always quite focused on. The concept of risk and credit/fixed interest has been thrown into a whole different dynamic over the last 12 months."***

Lane Clark & Peacock LLP (LCP) Senior Consultant and Head of Liquid Credit, Nick Cooney said, "The past year or so has been difficult, with de-risking and more con-strained liquidity budgets, but high yield is now looking more attractive. So, investors are moving away from some of the private assets they were previously allocating to and looking at these liquid asset within the high yield again."

WTW Global Head of Credit Research Kate Hollis, noted that high yield is a permanent fixture in the "return-seeking bucket" of defined benefit portfolios but she added, "Some countries are constrained by local regulations. In the UK, in particular, the charge cap makes it difficult to buy high yield in DC portfolios."

However, Oakglen Wealth's Nick Davis, Investment Director – UK, said he is concerned about the liquidity constraints associated with high yield.

"We are slightly more cautious about liquidity in fixed-income markets full stop and we think spreads are still relatively narrow over government bonds to justify that liquidity risk."

"With our larger family clients, we're often the most liquid part of their strategy. That's something we're always quite focused on. The concept of risk and credit/fixed interest has been thrown into a whole different dynamic over the last 12 months."

Giving a Middle Eastern perspective, Habib Investment Limited Head of Investment Advisory, Sandeep Jadwani, noted that investors in the region were more naturally attuned to high yield.

"The investment ideology is typically driven by a high disposable income and higher expenses, which make investors usually high risk by nature. They need to get that extra return by increasing the risk. We typically make our clients aware that the high-yield space is interesting

as it's not as interest-rate sensitive as Treasuries or IG, but is driven by the underlying sentiment and balance sheet of the particular corporate or sovereign."

By contrast, among the Italian retail clients at Mediolanum, fund analyst Paul Tsavalas noted a "tug of war with the safeness and familiarity of investing in BTPs [Italian government bonds]. We are trying to highlight that asset classes such as the high yield market are a prudent way to diversify exposure away from BTPs while not forgoing an attractive yield."

Role of high yield

WTW's Hollis noted that high yield can add some useful duration to portfolios as well as return, while LCP's Cooney described it as a helpful middle ground in terms of risk and return between other fixed income and equities.

"The evidence suggests it has done well over longer periods and looking forwards, it is likely to do better than it has done in more recent times when we've had a low interest-rate environment," he said.

Oakglen's Davis was a dissenting voice. He feels the underlying assets behind corporate high yield – equities – are overpriced. History, he suggested, points to caution.

"Back in 2008, everyone said, 'Run from equities,' and everyone piled into high yield. Hang on, you are not prepared to invest in this company but you are prepared to lend them your money? That's quite a crazy decision."

Countering that view, Barings' Sawyer noted that high-yield spreads had almost doubled from 2007/8 to close to 500 today.

> ***Panellists pondered the question of whether the fixed-income universe has caught up with the rapidly widening investment horizons of even the least sophisticated of investors."***

"Equity markets seem to be a one-way bet on rate cuts. With high yield, you are talking about lending to a company, generally speaking, at less than 50% loan to value for a three-to-four-year period where you get money back as long as the company doesn't go bust. It is a very different risk profile and much more in favour of the investor."

Both WTW's Hollis and Artemis' Holmes noted that covenants afforded protection not available to equity investors. Holmes also pointed to the asset class' greater bounce-back potential compared with equities.

In the credit crisis "high yield fully recovered from the trough within nine months – equities took almost five years. Over the long term you get a very good risk-adjusted return from high yield. That hasn't played out in last five years because of this very low-rate environment. But we're clearly out of it," he said.

Mediolanum's Tsavalas also noted the relative resilience of high yield.

"If we talk about the potential recovery rates when we do have these bad events, this is something this asset class can offer as opposed to equity, when you just lose all your capital."

Roundtable panellists discussed the image problem that has dogged high yield, including the unhelpful "junk bond" moniker. LCP's Cooney suggested comparing high-yield managers with the benchmark has contributed to high yield's dubious reputation, while WTW's Hollis said that investors harbouring the notion that fixed income is "proxy cash" are not doing the asset class any favours.

In fact, panellists noted that high yield is as diverse as the companies or entities behind it. Barings' Sawyer cited such behemoths as Telecom Italia, Virgin Media, Netflix and Formula One Motor Racing among the established, household names issuing high-yield debt in recent years.

Emerging market high yield

If high yield is already widely perceived as risky, what happens when you add emerging markets to the mix?

Habib Investment Limited's Jadwani said, "This boils down to the reach and understanding of ground-level reality – apart from the numbers we would typically see or the cash flow coming through, and the age and legacy of the company, we look at how systemically important that credit is to the country where it is based."

In the case of oil companies, where the risk is driven by geopolitics, "we are on the ground and we understand what an Adnoc is doing, what Oman Oil is doing," he added. "We know that as sovereign and systemically important entities, they won't default."

Artemis' Holmes was among panellists eschewing emerging market high yield.

"It is a different skillset. To my mind, it requires deep knowledge to understand the political system and how the company is integrated within that – and fundamentally we don't think we have any edge there to be able to do that. We therefore focus on developed market high yield, where our edge lies."

Panellists pondered the question of whether the fixed-income universe has caught up with the rapidly widening investment horizons of even the least sophisticated of investors.

WTW's Hollis said, "The fixed income universe has expanded enormously but the price is liquidity. Some of this newer stuff is complex but all of it is of limited liquidity compared to equities. That is the problem. When people decide they want to get out they either find they can't or they get hit with a walloping ADL [anti-dilution levy], or a swing. It's been exacerbated by certain fund managers providing daily liquidity on portfolios that are anything but, for marketing reasons."

Artemis' Holmes added, "The point about liquidity is misunderstood by most of the market – it goes back to the issue of people viewing things as single units."

"Maybe it's a simplistic way of approaching the market but it feels like there is a misunderstanding. 'I have my daily liquidity on my agency MBS portfolio, so why can't I get it on my subprime car loan portfolio?' Those are two radically different asset classes and we probably need to

be better in terms of communicating that to clients. “

High yield and sustainability

Sustainability is a major preoccupation for equity investors, though panellists were divided about the influence their high-yield counterparts can exert. They also noted that ESG was a nuanced arena and something of a minefield with ‘environmental’ and ‘social’ mandates often conflicting, for example, where a developing-world mine closure would put thousands out of work.

ESG risk abounds in certain industries, such as coal, tobacco, and gaming, panellists noted. However, in high yield, ESG as a risk factor is often overlooked.

Artemis’ Holmes said, “There are businesses that have fundamental risks associated with them that, despite high yield’s theoretical fundamental focus on risk, is totally ignored.

“To my mind, that’s analysis that needs to be done by an analyst that is individually covering the stock. It can’t be outsourced to an ESG specialist or a rating agency.”

WTW’s Hollis was among the more optimistic of panellists about high-yield investors’ ability to encourage good ESG habits.

“There are chunks of high yield that have no public equity, so the only room for engagement is through borrowing. “

Even private equity, not typically regarded as prioritising ethical niceties, has an incentive to listen to concerns about sustainability in order to refinance, she added.

“Engagement is water on stone. You’re not going to engage with someone where they suddenly say, ‘I’ve seen the light and I am going to change my whole business model.’ But if you make it difficult for them not to change their business model, or their attitude, or their data provision, or whatever it might be, it will change.”

Even in the US, where ‘bifurcated’ concerns about fossil fuels and diversity sometimes work in opposition to each other, companies are answerable to global investors, so need an ESG strategy, she added.

Barings’ Sawyer added that private equity also needs to have its ESG ducks in a row when it comes to ultimate exits via IPOs.

“They cannot execute on that in most markets unless they have a fully thought-through ESG policy.

Otherwise, the monetisation of their investment is more challenging.”

When it comes to ESG considerations, panellists rued a serious lack of reliable data.

Artemis’ Holmes said, “As investors we always value having a number and we sometimes forget that having the wrong number is worse than having no number.”

Giving an emerging market perspective from Dubai, Habib Investment Limited’s Jadwani said, “If ESG compromises on the return substantially, investors don’t want to get into ESG, primarily due to little or no knowledge, though with COP28 coming to the UAE there is a lot of buzz around it.”

Oakglen Wealth’s Davis noted that from a private client perspective, there is a huge diversity of views but warned of the impact of ESG on investment returns by reducing the available investment universe.

He added, “The governance factor is the key thing. If you have good governance the E and the S piece will probably follow with it. “

Artemis’ Holmes was cautious on elements in the claims of some green bonds, particularly in the US, even though, he said, they tend to issue at lower spreads than non-green bonds and trade better.

“My fundamental issue is that unless there is an incredibly clear narrative around ‘This is being used for X purpose, which will have Y outcome’, and it is very easy to measure, I would regard a green bond as just any other bond in that capital structure.”

Panellists also discussed the appeal of sovereign high yield . Habib Investment has significant exposure to GCC sovereign high yield, particularly of oil-exporting nations, said Jadwani.

He added, “Egypt stands out as a sovereign. The spreads are fantastic, the risk-reward profile is good, however, needs to be aligned with investor risk profile. We are very comfortable with GCC sovereign high yield, more than corporates.”

However, LCP’s Cooney felt that sovereign high yield requires “a different skillset. It’s more macro, rate-driven, top-down rather than bottom up.”

With economic uncertainty prevailing and the cost of capital high, recovery prospects for when things go awry is a burning question for high-yield investors. Panellists were generally sanguine.

Barings’ Sawyer said, “There are going to be some good-quality businesses that are going to default over next five years simply because of 10% cost of capital. In those businesses, we are going to see some very good recoveries. There will be other companies that will go bang and recoveries will be poor.”

However, he added, “It’s not the high-yield market of 2000, or 2005, where we’re really talking about small and medium-sized businesses in growth mode. It’s very

different now with large, established market leading businesses issuing high-yield debt.

That scale, size, and reason-to-exist could help underpin a reasonable recovery rate."

"Our base case is that defaults will remain manageable, call it 3 [percent], maybe 4. You are talking about anywhere between 100 and 200 basis points of credit losses in a single year."

Artemis' Holmes added, "Now the cost of debt is higher among treasurers, there is an incentive towards paying down debt. That's a tailwind in terms of credit."

Now the cost of debt is higher among treasurers, there is an incentive towards paying down debt. That's a tailwind in terms of credit."

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Roundtable Participants

Jack Holmes

Portfolio Manager, Fixed Income

Personal Profile

Jack manages Artemis' Global High Yield bond strategy alongside David Ennett and Ed Legget, and also manages the fixed income component of Artemis' Monthly Distribution strategy alongside David Ennett. Jack joined Artemis in June 2019 from Kames Capital, where since 2016 he co-managed a range of high yield bond funds and was involved in the management of the Strategic Bond strategy.

Before that, he was an investment analyst at Standard Life Investments. Jack began his career as an economist at Cambridge Econometrics after graduating from Trinity College Dublin with a first class honours degree in economics. He is a CFA charterholder.

Company Profile

Artemis is a leading UK-based fund manager, offering a range of active equity and fixed income strategies which invest in the UK, Europe, the US and globally. Established in 1997, our expertise lies in security selection and conviction investing, implemented by experienced, focused investment teams with significant expertise in their chosen disciplines.

Chris Sawyer

Head of European High Yield Investments Group

Personal Profile

Chris Sawyer is Head of Barings' European High Yield Investments Group as well as a member of the firm's European High Yield Investment and Global High Yield Allocation Committees. Chris is responsible for the portfolio management of several loan, high yield bond and multi-credit strategies.

Chris has worked in the industry since 2005. Prior to joining the trading team in 2008, he was a member of the portfolio monitoring team where he was responsible for the ongoing credit analysis of individual portfolio assets. Chris holds a B.Sc. in Economics and Business Finance from Brunel University.

Company Profile

Barings is a $362+ billion* global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate, and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.
*As of March 31, 2023

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Roundtable Participants

Sandeep Jadwani

Head of Investment Advisory

Personal Profile

Sandeep Jadwani, ACSI,CIB is an award winning, certified and qualified investment advisor. With over 15 years of experience in the industry specially catering to very High Net Worth Individuals, Single/ Multi Family offices and even corporates as their preferred investment advisor and manager.

As Head of Investment Advisory, with Habib Investment Limited, Sandeep oversees the CIO functions of the company including Asset Allocation, Risk Management, Product and Manager Selection as well as custodian and counter party selection. Responsible for strategy onboarding across asset classes including VC, PE, Alternatives as well as the usual Equity & Fixed Income strategies.

As a believer of the convergence of Finance and Technology since the early 2000's , Sandeep has been an integral part of the fintech community in the Middle East and is associated as a Mentor and Advisor with some of the most notable incubators as well as accelerators including New York University, Abu Dhabi – Venture Launchpad, Dubai Future Foundation, Start up Bootcamp, DIFC Fintech Hive, Microsoft for Startups, IIDF etc.

Nick Cooney

Senior Consultant

Personal Profile

Nick is a Senior Consultant at LCP in London and is responsible for high quality investment and manager research across a range of global fixed income opportunities. He has international experience helping some of the world's largest institutional investors meet their objectives and has expertise across traditional credit and more esoteric solutions.

Nick is Head of Liquid Credit at LCP and is a senior member of the Private Credit Team. He has a degree in Economics from Durham University and is an MBA Candidate at DUBS.

Paul Tsavalas

Fund Analyst

Personal Profile

Paul Tsavalas joined Mediolanum in 2021 as a Fixed Income Fund Selection Analyst, where his research coverage is primarily focused on credit, total return, and global bond strategies. Prior to joining, he worked as a Fixed Income Fund Selection Analyst for Nationwide Insurance in the U.S.

During his studies, Paul had a summer internship at Eaton Corporation where he worked in the aviation division. He holds a B.S. in Economics from The Ohio State University.

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Nick Davis

Investment Director - UK

Personal Profile

Nick has more than 30 years of experience in investment management. He began his career managing money for individuals at Kleinwort Benson before moving to Credit Suisse Private Bank in 1999.

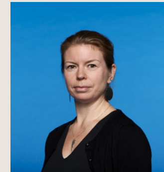
In 2005, he began working with institutional clients, specialising in charities at CCLA and pension funds at PSolve, before returning to managing portfolios for individuals, pensions, trusts and charities at Williams de Broe. More recently, Nick spent 10 years at Quilter Cheviot as a Discretionary Fund Manager, managing investments for private clients in SIPPs, ISAs, and Offshore Bonds.

In addition, Nick works closely with intermediaries both onshore and offshore. Nick is a Chartered Fellow of the Chartered Institute for Securities & Investment.

OakglenWealth

Moderator

Kate Hollis
Global Head of Credit Research



Elizabeth Pfeuti
Chief Client Officer

Personal Profile

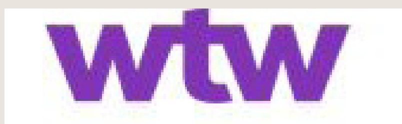
Kate Hollis joined Willis Towers Watson in Sept 2014 as a Manager Researcher on the fixed-income team.

She previously spent 10 years at S&P Capital IQ, most recently as Global Head, Fixed Income/ Alternatives Fund Research. Before that she spent 5 years working for funds of hedge funds and 15 years in fixed-income sales and trading in London and New York, working for Deutsche Bank, Daiwa Securities, Scotia McLeod and Schroders.

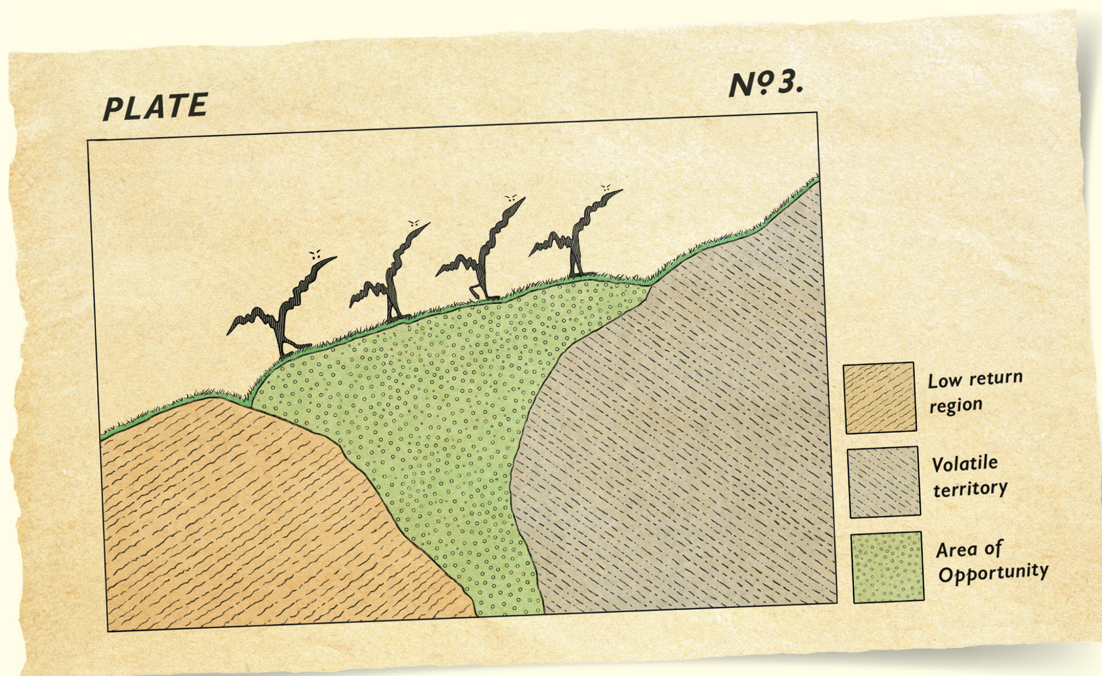
Personal Profile

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.



Artemis Investment Management offers a range of liquid, alpha-driven investment strategies across equity and credit markets globally. Our expertise lies in security selection and high conviction active investing.



The Artemis Global High Yield strategy seeks an attractive total return through a high conviction approach. By focusing on active security selection and under-researched areas of the high yield market, we believe we can generate equity-like returns with reduced correlation and lower drawdowns versus the market.

For more information, please contact
institutionalteam@artemisfunds.com

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Global High Yield – balancing the opportunities with the risks

"We see current bond market pricing of rate cuts in the second half of 2023 as being off the mark; we see neither benign enough inflation to allow, nor a deep enough recession, to demand such an outcome. We see our strategy of focussing on performing high yield credit without taking undue duration risk as being ideally suited to navigate this."

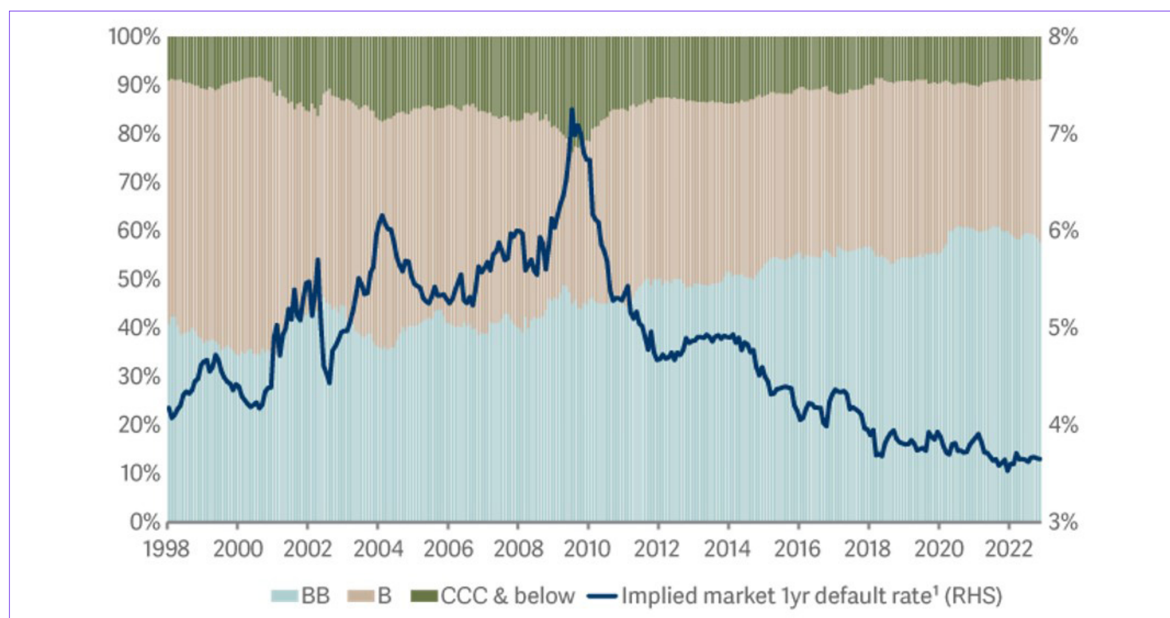
Following last year's change in interest rate regime and subsequent impact on bond markets, high yield bonds are offering a yield of around 8%. This is an attractive yield relative to the last decade and also to other asset classes. But is it enough to compensate for potential risks?

Default cycle

Given slowing economic conditions and rising interest rates, the first consideration is the default cycle. Default rates are close to record lows – S&P Global Ratings report that, for 2022, the global speculative-grade default rate rose slightly to 1.9%. This is still historically very low: according to the same S&P survey, this is just the ninth time in the 42 years covered in this study that the default rate was below 2% . What is certain is that it will rise from here – the question is by how much.

However, **the quality of the high yield market has improved since previous default cycles.** The high yield market looks very different to 10 years ago. It has never been higher quality than it is today – there are more BBs in the index and fewer CCCs (Chart 1).

Chart 1
Increasing quality
Highest quality part of the market – BBS – have significantly increased their share of the market



Source: ICE BofA Merrill Lynch Global High Yield Constrained Index as at 30 November 2022. [1]Implied market 1yr rate is based on S&P median default rates 1981-2021.

[1] Default, Transition, and Recovery: 2022 Annual Global Corporate Default and Rating Transition Study | S&P Global Ratings (spglobal.com)

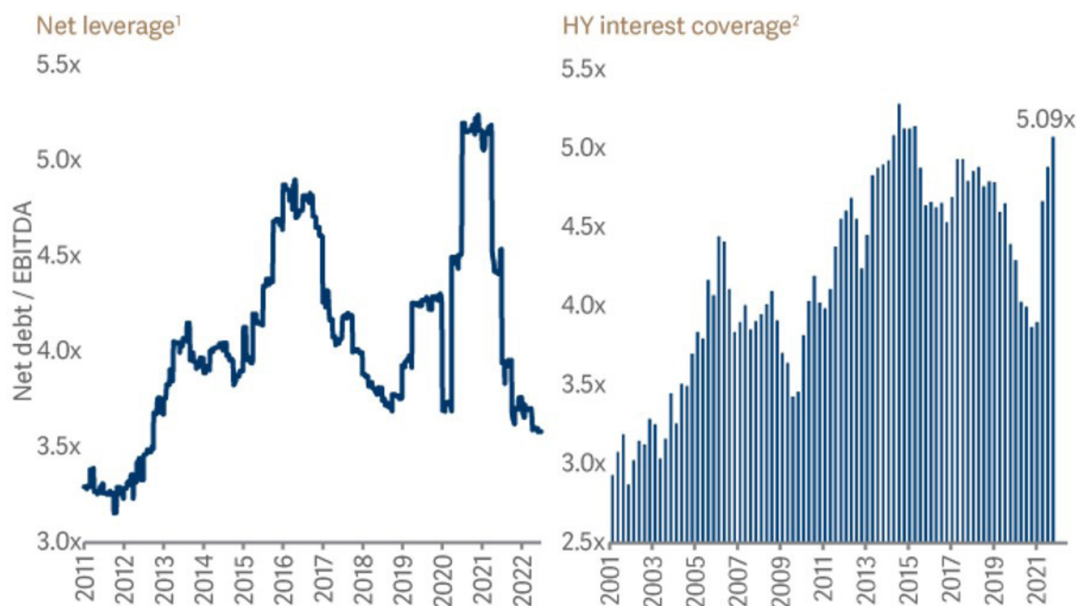
Author:

Jack Holmes
Portfolio Manager,
Fixed Income

BBs are much less likely to default than CCCs. Indeed, the difference in risk of default between the two ratings is stark. According to the same S&P survey quoted above, which covers the market from 1981, the risk each year of a CCC defaulting is 25.7%. Meanwhile the risk of a BB defaulting is 0.6%. So by avoiding CCC rated bonds, active managers can clearly mitigate against the risk of default.

At the same time, this improvement in quality is reflected in the fact that high yield companies have robust fundamentals: net leverage is relatively low and interest coverage relatively high (Chart 2). This suggests that high yield companies will in the main be better able to deal with higher interest rates than they have in the past.

Chart 2
High yield fundamentals look capable of dealing with higher rates



Source: 1BofA Global Research as at 31 July 2022. Data refers to US high yield bond issuers. 2Morgan Stanley 'US Cor po-rate Credit Strategy Chartbook' report. 1 June 2022. Chart data from Morgan Stanley Research, Bloomberg and Capital IQ.

Given this background, what areas of the market do we favour?

We focus on BB/B-rated bonds in developed markets. We prefer shorter-dated bonds so that we can avoid taking on too much duration risk. In an inflationary environment, we look for companies with pricing power and a competitive edge. One of the sectors we like is autos. We think that auto companies learned their lesson from the global financial crisis and now have lower leverage and more flexibility over costs. The transition to battery electric vehicles is also revealing winners and losers.

Unusually for a high yield fund, we are underweight telecoms. In the high yield market, telecom bonds have historically been regarded as safe havens because of their stable, predictable revenues, sticky customers, physical assets and relatively high credit ratings. Because of this, telecoms are a large weighting in most high yield funds. But is this safe-haven status justified? We think not – telecoms now appear completely commoditised. In addition, these companies are burning huge amounts of cash to roll out more advanced technology – whether it be 5G or super-fast fibre to the home. As a result, we see this as a significant area of risk in the market and we tend to avoid them.

In energy, we have a bifurcated view. We avoid US shale companies because of the relative economics in that sector, but we do invest in European companies in the energy sector because we think there are some attractive assets there which tend to be overlooked. In addition, under European law oil producers are required to provide extensive plans for decommissioning decades before the field comes to the end of its life, and are required to recognise the liabilities arising from this decommissioning on its balance sheet. Fundamentally we believe this not only takes away a significant downside risk for us, but also provides us with much more comfort that European energy producers can cope with the changing legislation that is likely to come through in future years around carbon reduction.

Outlook

There is little doubt that the financial stability concerns which flared up in March have added a new dimension to the 2023 outlook. We have sympathy with the view that an apparent trade-off between financial stability and fighting inflation may emerge amongst central bankers or, at the very least, will be debated by markets. However, we feel that the resilience built into the global financial system is such that, in time, policy makers will be able to refocus on their commitment to fighting inflation. We also continue to see strength and cautious optimism amongst the corporate sectors in which we invest. How the fight against inflation and economic resilience interact will continue to be, in our view, the dominant investment theme as we progress through 2023. We see current bond market pricing of rate cuts in the second half of 2023 as being off the mark; we see neither benign enough inflation to allow, nor a deep enough recession, to demand such an outcome. We see our strategy of focussing on performing high yield credit without taking undue duration risk as being ideally suited to navigate this.

In addition, as active managers we welcome an environment which will occasionally expose pockets of excess from the QE era, while simultaneously offering valuation support for the bulk of corporates who are masters of their own destiny.

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Three Reasons Why the Fixed Income Environment May Be Better Than You Think

"Perhaps counterintuitively, an environment where credit is less available could work in favor of investors in credit markets—both public and private."

While there are a number of risks creating volatility and unease across the market, there are also reasons to believe that today's fixed income markets offer a range of compelling opportunities.

Recession worries, inflation and tighter credit conditions are impacting fixed income investors, stoking fears of wider credit spreads and an imminent wave of defaults. While the volatility and general unease cannot be dismissed, investors in public debt markets may benefit from taking a step back and assessing the overall level of risk-reward on offer. In our view, and despite the prevailing negativity, investors are likely to find that fixed income currently offers a range of compelling opportunities. Here are three reasons why that is the case:

1. The Long-Anticipated Downturn

Starting in late 2021 as inflationary pressures mounted and major central banks' rate hiking cycles subsequently began, consensus has seen a recession as imminent. While certain countries such as Germany have technically already entered a recession, other major economies such as the U.S. may not follow until later in 2023 or early 2024—arguably making it one of the most widely anticipated downturns in recent history. That has given companies considerable time to prepare and there is little sense of foreboding among corporate management, who are managing costs closely and keeping inventory levels low. Many companies have also reduced leverage levels and proactively increased the maturity profile of their debt. For example, U.S. high yield companies' net leverage declined to 3.4x at the end of last year, from 3.7x a year ago, while interest coverage ratios increased to 5.9x from 4.8x during the same period.[1]

As a result, any earnings decline that occurs as growth slows is likely to be orderly, while default rates could be lower than in previous downturns. Indeed, high yield issuers are in a stronger financial position to ride out a challenging period than they were pre-pandemic, while the credit quality of the global high yield bond market has also improved considerably since the global financial crisis—BB issuers now comprise 52% of developed markets high yield, while single-B companies make up 39% (Figure 1).

[1] Source: JP Morgan. As of December 31, 2022

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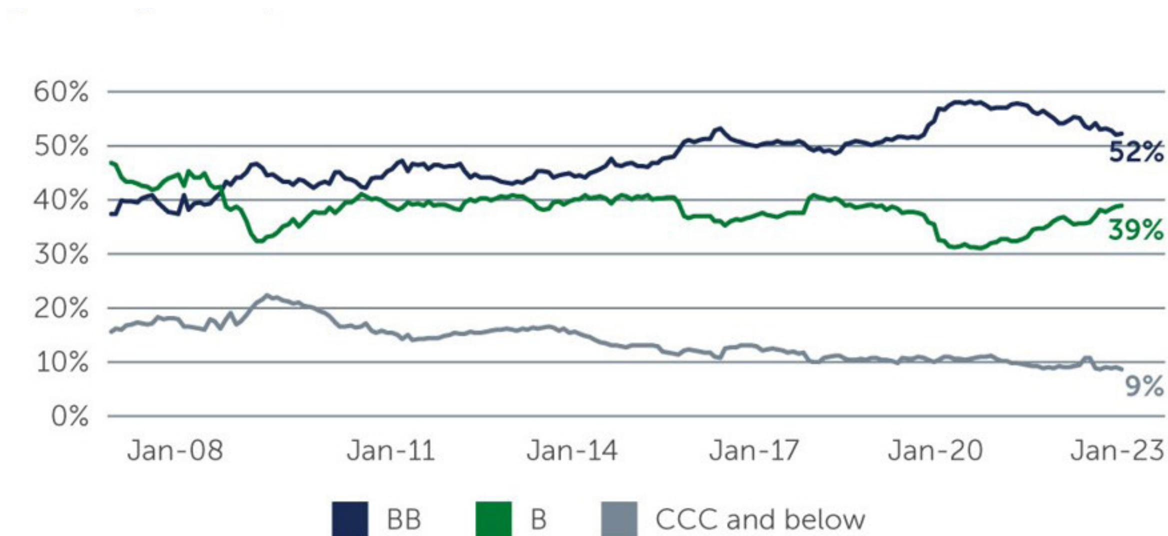
Figure 1: A Higher-Quality Market



Source: Bank of America. As of March 31, 2023.

While a recession will undoubtedly trigger some decline in credit quality, unemployment remains at record low levels and hundreds of thousands of jobs remain unfilled. If consumers stay employed, strong demand could continue in many sectors of the economy—which suggests that a downturn may be less severe than some forecasters expect.

2. Dislocations Create Opportunities

While the recent spate of banking problems is more a result of declining market values for high-quality bank assets than of lax lending standards, banks will undoubtedly move more cautiously going forward by making credit less available and more expensive. This is causing concern among public fixed income investors because a lower propensity by banks to lend could trigger liquidity problems for borrowers in public markets. But those fears may be overblown.

Perhaps counterintuitively, an environment where credit is less available could work in favor of investors in credit markets—both public and private. Opportunities to finance healthy companies that would otherwise have tapped banks are likely to increase and with the supply/demand dynamics moving in favor of lenders, investors can expect to earn not only attractive yields but do so with added structural protections. In essence, providing capital when capital is scarce can be an attractive source of returns for investors willing to take smart credit risk—even into a downturn.

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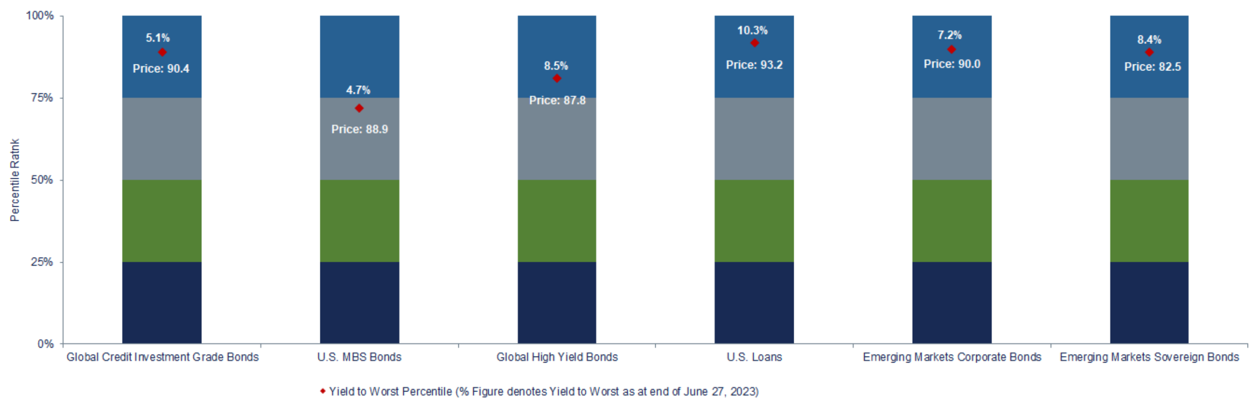
3. Yields Offer a Considerable "Margin of Safety"

While we acknowledge that uncertainty will persist and volatility is likely to remain high, a lot is already reflected in the price. Outside the depths of the pandemic, yields across most fixed income assets are at levels not seen since the global financial crisis and at which investors have historically generated attractive total returns (Figure 2). Trying to precisely time the right entry and exit points is extremely difficult, but fixed income offers the potential for higher and more dependable absolute returns than many other asset classes.

Figure 2: Yields Across Most Fixed Income Asset Classes Are in the 80th-90th Percentile Vs. the Last 20 Years



Source: Bank of America Merrill Lynch, Credit Suisse, Bloomberg, J.P. Morgan. As of June 27, 2023, 2023. ICE BofA Non-Financial Developed Markets High Yield Constrained Index (HNDC), Credit Suisse Leveraged Loan Index, Bloomberg Global Aggregate Credit Total Return Index, Bloomberg US MBS Fixed Rate Total Return Index, JP Morgan CEMBI Broad Diversified Index and JP Morgan EMBI Global Diversified Index. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

At Barings, we advocate for patient investing and diversification in helping our clients solve for challenges ranging from income generation to liability matching. Fortunately, there are more choices today than ever before to help achieve this—from corporate and sovereign bonds (both high yield and investment grade) across developed and emerging markets, to floating-rate loans, collateralized loan obligations (CLOs) and various flavors of asset-backed securities. Indeed, the investment universe is broad and deep.

In managing fixed income portfolios through the ups and downs of many past economic cycles, our team has found that markets generally overreact both to the upside and downside. For savvy investors, intent on finding both absolute and relative value through deep credit analysis, environments like the one we face today can therefore offer some of the best long-term opportunities for total returns.

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