

“HIGH YIELD BONDS OFFER A COMPELLING SOURCE OF INCOME”

- Investment trust managers comment on opportunities and risks for bonds

Investment trusts investing in bonds have been in high demand this year, with the **Debt – Loans & Bonds** sector currently the only investment trust sector trading on a **premium**. The sector trades at 2% premium, has an attractive yield of 8% and over one, five and ten years has returned 10%, 58% and 65% respectively.

Annabel Brodie-Smith, Communications Director of the Association of Investment Companies (AIC), said: “Actively managed investment trusts that invest in a range of bonds, loans and securities have had a storming year, with historically high yields attracting investors. The Debt – Loans and Bonds sector is in vogue and is currently the only investment trust sector trading at a premium.

“The investment trust structure allows bond managers to invest in less liquid bonds which are harder to buy and sell. The managers can also use gearing – borrowing to invest – which can be very helpful to take advantage of opportunities in the fast-moving bond markets.”

We asked investment trust managers from the Debt – Loans & Bonds sector whether bonds are still a safe haven and what risks they see ahead.

Are bonds still a safe investment?

Pieter Staelens, Portfolio Manager of CVC Income & Growth, said: “The economic environment is uncertain but corporate earnings are holding up well, as indicated by most equity indices at or near all-time highs. Debt is by definition less risky than equity, so for investors who want to lock in some profit on their equity investments and still get a return on their capital with better downside protection, high yield bonds or leveraged loans are a good place to be.”

Rhys Davies, Manager of Invesco Bond Income Plus, said: “While they are not risk-free, high yield bonds offer a compelling source of income. With careful selection and active management, we can build a portfolio that delivers attractive income relative to cash. Furthermore, many high yield bonds still trade below par, offering the added potential for capital gains.

“Market fundamentals are supportive of high yield bonds right now. Corporate earnings are stable or growing, and demand for the asset class remains strong, enabling companies to refinance on favourable terms. However, this positive backdrop has also compressed yields from the highs of 2022-23. In an asset class where the upside is capped and downside risks persist, disciplined bond picking is essential.”

Eoin Walsh, Manager of TwentyFour Select Monthly Income, said: “Investors should always be cautious and aware of the risks involved when looking at high yield bonds. The term ‘high yield’ usually refers to corporate bonds that are rated below investment grade, meaning a rating of BB+ and lower. However, we find that sub-investment grade bonds issued by banks and insurance companies, as well as asset-backed securities, often offer much more attractive risk/reward characteristics than corporate bonds.

“We have seen strong demand for corporate bonds in recent months which has left credit spreads – the premium investors demand for holding corporate risk over government bonds – tighter than the long-term average, at a time when macroeconomic uncertainty is elevated. However, credit fundamentals such as corporate, bank and consumer balance sheets look to be in robust shape, and therefore tighter spreads are arguably justified in many cases.”

Adam English, Fund Manager of M&G Credit Income Investment Trust, said: “Whilst high bond yields currently appear attractive, yields are facing various economic headwinds in the shape of budget deficits, significant growth headwinds, tariff uncertainty, and stubbornly high inflation. For these reasons we prefer floating-rate corporate debt which has a ‘risk free’ yield moving broadly in line with the Bank of England base rate combined with a yield premium related to the corporation we are lending to. Hence portfolio returns more accurately reflect the strength of where our expertise lies, which is credit selection and analysis.”

How are you actively managing the portfolio to enhance returns?

Ian “Franco” Francis, Investment Manager of CQS New City High Yield Fund, said: “A high yield portfolio is always closely monitored. The aim is to get stock selection right at the time of purchase and hold for the duration. There are a couple of reasons to sell; firstly it outperforms or is bid for, or secondly the company is underperforming and will have difficulty in repaying or refinancing its debt, or negative external politics affect the company.”

Rhys Davies, Manager of Invesco Bond Income Plus, said: “At the bond level, we always focus on analysing a company’s strengths and weaknesses and their ability to repay their debt. We’re comfortable to hold bonds from lower-rated issuers or highly indebted businesses if we

believe the yield compensates for the risk. Even in today's relatively expensive market, we're still finding many attractive opportunities.

"At the portfolio level, we've become more cautious. Diversification across issuers and sectors remains key, but we've increased the overall credit quality of the portfolio. Almost a third of the portfolio is now in investment grade bonds or cash. Within high yield, we've tilted towards BB-rated bonds and reduced exposure to B and CCC. Across the board, we're exercising caution in our bond selection which is the right approach in this market. As we have reduced exposure to higher risk areas, the yield of the portfolio has reduced a bit too, relative to some in this part of the market. But our volatility of returns has also fallen. We're happy with our positioning."

Eoin Walsh, Manager of TwentyFour Select Monthly Income, said: "We continue to focus on areas where we have deep expertise and that we think offer compelling value over some of the more traditional corporate bond markets, such as bank capital, insurance bonds and parts of the asset-backed securities market. The portfolio managers continue to take advantage of the new issue markets and are actively looking for opportunities to help optimise the risk profile for investors."

Adam English, Fund Manager of M&G Credit Income Investment Trust, said: "We are focusing on investing in private credit where we can achieve higher returns compared to similarly rated public credit markets. We are ultimately being rewarded for being prepared to hold assets from inception to maturity (the illiquidity premium) and the ability to analyse, monitor and rate these investments on an ongoing basis. This private credit premium in addition to the largely floating rate exposures have allowed us to outperform comparable public market indices over one-, three- and five-year time horizons."

Is corporate debt more attractive than government debt and why?

Eoin Walsh, Manager of TwentyFour Select Monthly Income, said: "For certain risk levels and maturities, spreads on corporate bonds and other assets such as bank capital and asset-backed securities remain compelling in our view. Gilt yields are high, mainly in longer maturities, but with renewed focus on the poor fiscal position of the UK, taking long duration risk does not look compelling. Staying shorter dated and targeting bonds with more attractive spreads is a more prudent way to generate attractive income."

Pieter Staelens, Portfolio Manager of CVC Income & Growth, said: "Government debt in many countries is only going one way, and that's higher. The only ways to reduce the ratio of debt to GDP are a) higher taxes, b) lower spending, c) inflation, d) GDP growth or e) default."

Generating GDP growth is not easy and none of the other strategies are very popular amongst voters. We typically lend to large corporates, with average revenue of more than €2bn, which are geographically well diversified with very strong management teams.”

Ian “Franco” Francis, Investment Manager of CQS New City High Yield Fund, said: “Spreads in the high yield sector of the market where we invest are nowhere near as tight as investment grade securities. We believe that government debt could weaken further but not necessarily weakening corporate bond markets to the same extent.”

What are the main risks with bond funds?

Rhys Davies, Manager of Invesco Bond Income Plus, said: “The primary risk in a high yield bond fund is credit risk, which is the possibility that a borrower fails to repay their debt. This is managed through rigorous credit analysis and understanding the economic backdrop.

“The second key risk is duration risk – the sensitivity of bond prices to interest rate changes, which is closely linked to inflation. Rising yields mean bond prices fall, so managing duration exposure is also important.”

Eoin Walsh, Manager of TwentyFour Select Monthly Income, said: “The poor fiscal position of many countries poses a risk for central banks and for investors, volatility is high, and we think the case for investing in very long dated bonds is poor. Geopolitical risks in particular are elevated, which could provoke spread widening. Tighter spreads are justified by healthy fundamentals and the solid GDP growth currently being enjoyed globally, but spread widening can be painful for investors, especially in longer maturity bonds, so we need to balance the attractive yields available against tighter spreads in order to target attractive returns without taking undue risks.”

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