Fund Manager Q&A

Encouraging Signs Ahead for High Yield

By Esther Pak | 04-20-11 | 06:00 AM | E-mail Article

Sandy Rufenacht, the founder, CEO, and chief investment officer of Three Peaks Capital Management, recently participated again in our Take Five. As portfolio manager of Aquila Three Peaks High Income (ATPAX), he answered our questions on whether his biggest worry was interest-rate or credit risk, as well as whether the two-year runup in high-yield bonds triggers any concerns regarding a potential downdraft.

He also discussed ways that management plans to capitalize on some promising trends that they foresee for the rest of 2011. Finally, he commented on his stance on increasing mergers and acquisitions activity and ways management plans to cushion against some of the risks of this trend.

1. What's your bigger worry right now: interest-rate or credit risk? Why?
Should the economy regain traction, we would expect upward pressure on Treasury yields because of inflationary pressures brought on by expanded global liquidity, global economic growth, and a looming federal budget deficit. We have already seen several countries around the world begin to raise short-term interest rates in an attempt to combat inflationary pressures, which could signal that the Federal Reserve is not too far behind.

While we are more inclined to believe that economic activity will continue to rebound to a level which causes Treasury rates to increase and job creation to occur, we also think that there remains a risk that economic activity could decline because of uncertainty over the strength of the economic recovery, the strength of the consumer, the financial impact of persistently high unemployment, and the possibility of below-average growth for an extended period of time, in addition to tensions in the Middle East and other geopolitical uncertainty. It is because of this uncertainty that we remain focused on higher-quality companies that operate in reasonably predictable economic industries, while continuously monitoring the maturity and duration characteristics of the portfolio.

Defaults are expected to remain minimal throughout the year. Given the rapid rise in commodities and the potential impact it may have on the consumer, company-specific results and forecasts will be important indicators of cost containment and consumer demand. The default rate ended the quarter at 0.8%, basically where it has been for the last five months. The default rate remains well below the 25-year average of 4.3% and is expected to remain low over the foreseeable future as there are not many default candidates in today's environment.

At the end of the first quarter of 2011, nearly 85% of the market traded above 100% of par. Distressed debt, or bonds trading below 50% of par, remains minimal and hovered around 0.3%, or approximately $3 billion, during the quarter. Bonds with a price lower than 70% of par, a more conservative measure of distressed debt, also remain minimal and finished the quarter at $13.5 billion, or roughly 1.3% of the market. These amounts are vast improvements over levels seen during 2009, and even most of 2010, and continue to indicate that there simply are not very many default candidates in the current environment.

2. Given the fund's emphasis on providing downside protection, are you nervous about the high-yield market's prospects given the two-year runup in high-yield bonds and the fact that the sector isn't exactly cheap at this juncture? Are you taking steps to protect your shareholders against a potential downdraft?
Demand for high-yield bonds continued to be robust throughout the first quarter, with $8.9 billion coming into the asset class. The only weakness seen from a flow perspective was in the two weeks following the earthquake in Japan, when an estimated $1.2 billion flowed out of the asset class. We continue to expect inflows into the asset class as investors search for yield against other fixed-income asset classes and continue to look for less volatile alternatives to generate a return.

The strength in high yield during the first quarter of 2011 was fairly broad-based across the ratings spectrum but remained more prevalent in the higher-beta names as a result of the continuation of the flight-to-risk trade. While every industry was positive for the quarter, many of the consumer-related industries were among the worst-performing industries in the index as the rise in oil weighed on investors' minds. The airline industry was the weakest performer with a 0.88% return, followed by restaurants at 1.81%, textile/apparel at 2.04%, and home construction at 2.11%. Companies reported fairly strong fourth-quarter 2010 results and generally provided a positive outlook for 2011. Operating performance continued to show signs of strength as a result of growth in revenues and margin expansion; however, scrutiny on forecasts during the coming quarters will be heightened given the headwinds facing consumers and businesses because of commodity pressures.

We continue to place a heavy emphasis on stability in the investment-selection process by highlighting industries and companies that show predictability in operating performance and exhibit bondholder-friendly actions. We continue to avoid highly cyclical industries because the volatile operating trends inherent in these industries can be problematic when trying to support a balance sheet that has debt. We also remain concentrated in the one- to three-year duration segment as we continue to believe that upward pressure on Treasury yields could occur once the Federal Reserve eases its purchases of Treasury securities. We constantly monitor the credit risk and interest-rate risk of every security in the portfolio, as we strive to be prudent financial stewards through our investment process.

3. While the fund's focus is on providing solid downside protection, what are some ways management foresees capturing upside potential for the rest of 2011? What are some specific trends on which management anticipates capitalizing?
We continue to see encouraging signs in the business operating environment that lead us to believe that the relative strength in high yield can be sustained. Many high-yield companies reported increasingly better results throughout 2010, in addition to refinancing debt maturities and strengthening their balance sheets. High-yield debt maturing between 2012 and 2014 has been reduced significantly during the last two years, which has provided a much larger maturity cushion than what we saw in 2008. We have even seen many companies refinance 2015 and 2016 maturities in an attempt to reduce interest costs and extend maturities.

Key technical indicators of the high-yield market, such as spreads and the default rate, remain favorable, and the asset class continues to experience positive inflows.

We also believe the asset class could continue to benefit from a reallocation out of Treasuries and other duration-sensitive securities, as investors search for higher-yielding fixed-income securities and less exposure to interest-rate risk.

With that said, we remain cautious with regard to lower-rated and more cyclical companies as we believe any falter in economic strength could affect the ability of these types of companies to support leverage and reduce debt. Additionally, with Treasury rates potentially on the rise, we remain focused toward the shorter end of the maturity spectrum so as to avoid interest-rate risk to the extent possible. We continue to believe that once the Federal Reserve stops supporting lower rates through open market purchases of Treasury securities, rates could move higher as long as the economy remains firm.

4. Given that you typically maintain a higher-quality portfolio than your typical high-yield rivals, are you concerned that your fund would respond more negatively to interest-rate shocks than its peers? If so, are you taking any steps to prevent that from happening?

As mentioned previously, we place a heavy emphasis on stability in the investment-selection process by highlighting industries and companies that show predictability in operating performance and exhibit bondholder-friendly actions. We continue to avoid highly cyclical industries, since the volatile operating trends inherent in these industries can be problematic when trying to support a balance sheet that has debt. We also remain concentrated in the one- to three-year duration segment as we continue to believe that upward pressure on Treasury yields could occur once the Federal Reserve eases its purchases of Treasury securities. We remain focused on the shorter end of the maturity spectrum in order to avoid interest-rate risk to the extent possible.

In our opinion, both the Treasury market and the equity market could experience heightened volatility during the foreseeable future as investors try to assess the strength of the economic recovery, the strength of the consumer, the financial impact of persistently high unemployment, and the possibility of below-average growth for an extended period of time. In addition, sentiment with regard to these important issues could be adversely affected because of recent commodity inflation and elevated oil prices, which remained above $100 a barrel for most of March.

5. Many companies are issuing debt to finance acquisitions. What are the risks of this trend, from your perspective, and how does the fund manage that risk?

Mergers and acquisitions are likely to become more of a factor in the high-yield market throughout the year as companies seek to grow. Other shareholder-friendly actions will also likely become more prevalent in the form of increased dividends and share repurchases, which will largely be at the expense of bondholders. New issuance is likely to become more aggressive from a quality, structure, and covenant perspective throughout the year and will need to be monitored closely. Generally, we expect credit trends to remain positive in 2011 as companies continue to show the ability to endure slower economic growth while strengthening their balance sheets; however, we do believe increased mergers and acquisitions and leveraged-buyout activity is on the horizon, which could pressure ratings and lead to increased fallen angel activity.

Primary issuance continued to be very strong during the first quarter of 2011,

generating the second-highest quarterly issuance on record following the $91.3 billion that priced during the fourth quarter of 2010. March issuance marks the eighth time in the last 13 months that high yield has priced in excess of $30 billion in a single month, a feat that had never been seen before 2010. Acquisition/LBO financing amounted to 13.0% of new-issue proceeds, which actually compares favorably with the 15.6% of new-issue proceeds experienced in 2010. Refinancing activity remains strong, accounting for 63.8% of the proceeds during the quarter. By comparison, 66.5% of the proceeds during 2010 were used for refinancing debt versus only 35.2% of proceeds during 2007.

Credit quality of new issuance was somewhat concerning during the quarter, with 12.4% of the deals being rated CCC. This still compares favorably with the 2007-08 timeframe when nearly 16.0% of issuance was lower-rated, but it is higher than the 8.0% of issuance that was lower-rated in 2010. Another concerning characteristic is that 2.1% of the issuance during the quarter was structured with a pay-in-kind and/or toggle interest payment. The amount still compares very favorably with the near 11% during 2007 and 2008, but it is much higher than the 0.4% experienced during 2010.

We continue to look for companies exhibiting bondholder-friendly actions such as repaying debt and/or refinancing nearing debt maturities thereby enhancing balance sheet strength, as opposed to stock buybacks, dividends, or other shareholder-friendly actions. We will maintain our discipline of minimizing volatility by generally avoiding bonds that appear to have stocklike characteristics, such as: CCC rated debt, distressed debt, emerging-markets debt, PIK bonds, toggle features, convertible bonds, preferred stocks, and common stocks. Avoiding the more aggressive financing, and issues with equitylike risk, is characteristic of our investment process.

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