NORTHEAST INVESTORS TRUST

Why Flexibility is Key to Managing Risk in the High Yield Market

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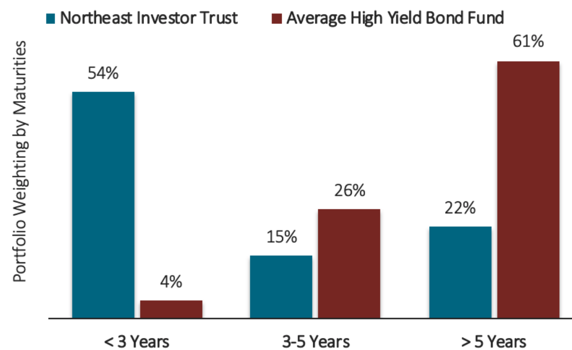
The sudden selloff triggered by the COVID-19 pandemic highlights the advantages of high yield bond funds that have freedom to maneuver

There was a growing feeling, heading into this year, that high yield bonds might be *less* risky than some investors thought. That was partly due to an economy that, at the time, looked to be on decent footing and the relatively short duration of high yield funds, exposing investors to modest interest rate risk.

Then came the sudden market shock as large parts of the global economy were shut down to slow the spread of coronavirus. The selloff, which pushed risk assets into a bear market, illustrated how some high yield funds might actually be *riskier* than expected, as the downturn exposed issues within some portfolios including, but not limited to, high yield ETFs. However, actively managed funds with more freedom to maneuver fared much better.



Sources: Morningstar, Northeast Investors Trust

Beyond Duration

The average duration of a high yield bond fund is 2.7 years, which is decidedly shorter than the 6.2-year duration for the total U.S. bond market, according to Morningstar. But a lower duration alone doesn't express the full risks associated with investing in a fund. For example, less than 7% of the holdings in the SPDR Bloomberg Barclays High Yield Bond ETF will mature within 3 years, compared with 20% for the broad bond market. Meanwhile, 70% of this ETF won't come due for 5 years or longer. Generally speaking, actively managed high yield funds aren't any safer. Less than 5% of the average high yield fund matures within 3 years, while more than 60% won't come due for 5 years or substantially longer.

Why does this matter? The COVID-19 selloff unfolded with record speed, and funds with longer-dated securities faced the full brunt of that volatility as most of their holdings were exposed to short-term losses.

At Northeast Investors Trust, on the other hand, we enjoyed a decided advantage. In recent years, we seeded one end of our portfolio with short-duration yield-to-call securities as a ballast for downside protection. In fact, more than half of our fund is due to mature within the next 3 years. And roughly 10% of the Trust converted to cash since the start of the year as they either matured or were called by their issuers.

Those bonds suffered zero capital losses and this strategy helped us in several ways. First, it protected the principal value of the portfolio. Because we knew how much of the portfolio would convert to cash at par, it allowed us to approach this crisis with relative calm. It also provided liquidity for the Trust to meet routine redemptions without having to sell at losses, which many funds had to do. And the cash allowed us to selectively bargain hunt after spreads flared out.

Limiting Exposure to COVID

The specific nature of the economic downturn sparked by the coronavirus pandemic also created problems for high yield index funds and some actively managed portfolios that secretly hug high yield indexes.

For starters, this has been a consumer-led shock, as governments in February and March began shuttering large parts of the consumer sector—including airlines, hotels, entertainment venues, restaurants, and retail storefronts—to enforce social distancing. While consumer cyclical companies such as retailers represent less than 10% of the U.S. stock market, they make up more than 16% of the high yield securities in the Bloomberg Barclays High Yield Very Liquid Index.

Moreover, restrictions on the economy worldwide have led to slowing demand for energy, which sparked a price war among global crude oil producers in the first quarter. As it happens, this has also had a disproportionate effect on the high yield market. While energy makes up only 3.6% of the S&P 500 index, the sector's influence in high yield is more than three times as large, with issuance from energy companies making up more than 11% of the Bloomberg Barclays High Yield Very Liquid Index.

At Northeast Investors Trust, we have always enjoyed the flexibility to avoid certain areas of the high yield market as well as certain industries within sectors—if they do not offer good valuations, income, or risk-adjusted total return opportunities.

As a result, we entered the first quarter with very little exposure to debt issued by retailers, as we have been concerned in general about the rapid disruption taking place in the sector. And while we have been roughly market weight energy overall, within the sector we have selectively owned natural gas companies such as CNX Resources while limiting exposure to oil exploration and production companies, which have been hit hard by the crash in crude prices.

Oil prices are being driven by a complicated mix of factors that go beyond the pandemic shock, so we continue to monitor this area. At the moment, we believe the recovery—once retail and travel are unfrozen—will be more "U"-shaped than "L"-shaped, offering some potential opportunities for investors.

Buying, But Selectively

The coronavirus pandemic has had another effect on high yield: Several large bond issuers that were struggling to hang onto their investment-grade status were recently downgraded in the economic crisis.

These Fallen Angels include several consumer names such as Macy's, Kraft-Heinz, Tapestry (which owns the luxury retailer Coach) and Capri Holdings (parent of luxury brands including Michael Kors and Versace). This new batch of debt—including short- and long-maturity securities—must be absorbed by high yield index funds. And those funds will, in turn, be forced to sell other holdings in their portfolios to make room for the Fallen Angels, effectively locking in losses in the midst of this downturn while boosting exposure to the vulnerable consumer economy.

At Northeast Investors Trust, we aren't obligated to bring Fallen Angels into our portfolio. Instead, we have the flexibility to redeploy the proceeds of our yield-to-call securities much more selectively. For instance, we recently picked up credit bonds issued by Ford Motor Credit yielding 13%; the telecom provider CenturyLink yielding 8%; and the copper and gold mining company Freeport- McMoRan yielding 9%.

Many of the names we added were rated BB, at the upper end of the high yield credit spectrum. And we generally favored non-cyclical issuers, as well as shorter-term bonds maturing in just 2 to 3 years. That's because we still believe it's worth maintaining some ballast for downside protection, especially since the COVID healthcare crisis—and the corresponding economic shutdown—have yet to be resolved.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (ticker: NTHEX) ,a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers, having run Northeast Investors Trust for more than 30 years. He received his A.B. from Harvard College and his M.B.A. from Harvard Business School.

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