In a low-rate environment, more high-yield companies are looking to refinance their bonds to a lower coupon level. How can an investor potentially profit from this trend? Western Asset’s Short-Dated High-Yield strategy targets bonds that are more likely to be tendered before their first call date—at a premium. Using bottom-up quantitative and qualitative analyses, Western Asset has identified short-duration high-yield bonds (typically with call protection expiring in the next two years) that are more likely to be called early. Product Specialist Thomas V. McMahon and Head of Credit Michael C. Buchanan in this Q&A discuss how this strategy works from a client and investment-management perspective, including how the strategy would likely fare in a rising rate environment.

Q: What is a Short-Dated High-Yield strategy?

MCB: Many high-yield companies have been seeking to take advantage of this low-rate environment by reducing their short-dated maturities and locking in longer-term financing. One way they are accomplishing this is by tendering for their high-coupon shorter-maturity bonds before the call protection expires. In order to entice investors to part with their bonds, companies have been offering a premium to current market prices. Our Short-Dated High-Yield strategy seeks to capitalize on that tender premium by investing in high-yield bonds that in general have a short maturity (five years or less) and that have call protection expiring in the next two years. The strategy is to buy bonds at what we feel is a relatively compelling yield-to-call and which we believe will be tendered for prior to their call date.

Q: What added value does Western Asset bring to this opportunity?

TVM: Western Asset manages approximately $20 billion in high-yield securities. We have one of the largest dedicated high-yield teams in the industry—including 12 high-yield credit analysts with an average 17 years of experience in the business. The size of our team and the depth of our resources allow us to do extensive research on a significant percentage of the market, including exhaustive covenant analyses. Due to our participation in the origination process—which would include structuring bond covenants—we’re very much aware of those high-yield issuers that have shorter-dated maturities and specific covenant features that restrict these companies from pursuing certain desirable corporate actions. We believe these insights into the structure of the bonds and management give us a competitive advantage when looking for tender candidates in the marketplace.

Q: How does Western Asset determine which companies are likely to tender?

MCB: There are two kinds of analyses we perform. The first is a quantitative assessment, which is based on the net present value (NPV) calculation. We look at the savings that the company will get by refinancing a higher-coupon bond with a lower-coupon bond, and we take the net present value of that. We then compare that savings to the tender premium that the company would have to pay to take the bond out of the market. A positive NPV calculation means that the interest rate savings are greater than the tender premium costs. In that case, a company would be more likely to want to tender those bonds. If the NPV calculation is negative, the tender premium costs outweigh the interest rate savings. Although a company may be less likely to retire the bonds early with a negative NPV, there are
other reasons why a company might want to tender. We also do a qualitative assessment, which includes analyzing high-yield bond covenants. We look at the bond indenture to fully understand how restrictive the covenants are for a company. More restrictive covenants could increase the likelihood that a company would want to tender before the first call date.

Q: Can you give examples of those kinds of qualitative factors?

**MCB:** For instance, say there is a restriction that impedes a company’s ability to reinvest in its own business, resulting in an accumulation of cash on the balance sheet. That could create a strong incentive for a company to tender the bonds even if the NPV calculation is negative. Corporate strategy considerations are a factor in a company’s desire to tender. For some companies, the earnings-per-share (EPS) impact and the multiple that they are getting in the equity market are compelling enough for them to actually be incentivized to take that interest cost down from, for example, an 11% coupon bond to a 7% coupon bond. Some of these analyses are very straightforward, while others require in-depth research. It is in these situations that we believe Western Asset has a competitive advantage due in large part to the depth and experience of our credit research resources.

Q: Why would a company be willing to tender when, on paper, the premium costs outweigh the interest rate savings under a calculation like NPV?

**MCB:** Although quantitative considerations like NPV are important, the qualitative assessments that I just mentioned really are the main drivers of a company’s decision to take a bond out early. If the NPV calculation is negative, it doesn’t automatically mean that the company will simply turn its back and walk away. The company will look at other factors, like how do the bond covenants restrict its ability to operate the company or the impact on EPS. In some cases, a company is motivated simply by an aversion to debt. Over the last five years of choppy markets, the pain suffered from having too much debt on the balance sheet has been severe, creating a strong debt aversion. A company may look for ways to retire debt, even if those methods don’t make economic sense on paper.

Q: What types of bonds are you targeting under this strategy?

**TVM:** We are targeting primarily bonds that have above-market coupons, five years to maturity and two years left to call. But our universe isn’t limited to bonds with maturities of five years or less. We will look at bonds with maturities as long as seven years. In these cases, we must be of the opinion that there is a very, very high probability that the bond will get taken out before its first call date. In other words, such a longer-maturity bond needs to have a very high coupon, trade at a very high dollar price relative to the call price, and may have some qualitative aspect that would encourage a tender. Say we are wrong, and the company opts not to call the bond as expected. The portfolio could actually benefit from this scenario, as well, because the longer we keep earning that above-market coupon, the more our overall return would be enhanced.

Q: Does this strategy offer any additional benefits in today’s market environment?

**TVM:** With the general level of US interest rates near historic lows, many investors are concerned about how they can protect themselves from rising interest rates. We believe a Short-Dated High-Yield portfolio would perform well in such an environment. Our Short-Dated High-Yield model portfolio currently has an effective duration of approximately 1.63 years, which in and of itself limits the impact of higher rates. In addition, historically, the high-yield asset class has not been particularly sensitive to changes in interest rates, and we believe sensitivity will be even lower with Short-Dated High-Yield. If interest rates rise sharply over a short period of time, there really should be little impact to the Short-Dated High-Yield portfolio.
Q: To what extent is Western Asset deploying this strategy in its portfolios?

**MCB:** We think it’s a real interesting subsegment of the high-yield market right now. Short-Dated High-Yield is definitely expressed in all of our high-yield portfolios. On average, the strategy represents about 20% of our overall portfolio. The downside to owning it more exclusively relates to the fact that the stated yield-to-call remains below where the overall high-yield market is. Although we think that the strategy’s total rate of return is pretty compelling and is competitive with a more generic, run-of-the-mill high-yield, the reality is that it does lower book yield. Speaking hypothetically, say the Short-Dated High-Yield’s yield-to-call is 200 basis points lower than the overall high-yield securities. The short-dated therefore produces less income than the overall high-yield securities that we own. This trade-off between income and yield is a reason why Short-Dated High-Yield doesn’t occupy a greater share of our dedicated high-yield portfolio. But, again, we think there can be an offset for that trade-off, which is the ultimate total rate of return that we would expect to see as a result of an early call.

Q: What is the origin of this strategy at Western Asset?

**MCB:** Many of our clients have expressed concern about what rising interest rates would mean for their overall investment plans. Though it has not been Western Asset’s view that there will be a rapid rise in rates in the near future, we have been discussing strategies to be deployed that could dampen the impact of such an event on our portfolios. During the course of our regular meetings within the high-yield team, the compelling risk-rewards of Short-Dated High-Yield securities became a frequent topic of conversation. This was the genesis of the idea that evolved to the strategy we have today. The process we undertook to get here represents a very good example of the internal collaboration between the business and the investment teams.

Q: How long is this strategy viable?

**TVM:** There’s approximately $250 billion of high-yield that is callable within the next three years. So the opportunity is really within that time frame. To participate fully in this strategy, you would ideally be invested before the tenders occur. So you would want to consider making an investment within the next six months, with a termination within the next three years.

**MCB:** This is designed to be a tactical strategy. It’s not something that we are going to advocate that clients own throughout a cycle. There is a precise moment during the credit cycle when this has a very skewed risk/reward that could be favorable to clients. I think we are in that moment now. That window may be as short as 1½ years and it may be as long as three years, but we believe that we are there and that this may be an opportune time.