How Taxable Fixed Income Is Helping Managers Preserve Principal and Find Yield

By Jennifer Banzaca

In today's low-interest-rate environment, principal perseveration a key fundamental present in bond strategies and managers must find yield without taking on too much undo risk.

During the Taxable Fixed Income session at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Sanjai Bhonsle, CEO of StoneCastle Financial Partners and Partner and Portfolio Manager for ArrowMark Partners' corporate credit and lending business, said his firm's investment philosophy is not to chase yield capital preservation. During the first half of 2020, Bhonsle said there was a meaningful amount of dislocation in the market allowing his fund to invest a significant amount assets at a deep discount, thereby enhancing yield.

"One other way to enhance yield is to buy assets at a discount from forced sellers, so that's kind of how we have navigated through this low-yield environment," Bhonsle noted.

Larry Holzenthaler, an Investment Strategist and Analyst at Symphony Asset Management, noted there is significant disparity between current yields, or the cash-on-cash yield, of high-yield bonds, and the current yield of loans.

"We've noticed a good deal of money coming into high-yield funds, and at the same time there's actually money coming out of so-called floating rate funds. And there clearly is this divergence between demand in high-yield and demand in floating rate being driven, at least in some part, by the difference in current income," Holzenthaler said.

Holzenthaler added that looking at a yield to maturity concept or IRR and not just the current cash on cash, the return potential between high yields and loans is similar.

"You're getting roughly the same return potential out of loans in high-yield. While you're getting more cash-on-cash current income today with high-yields, the return potential would be roughly in line for a portfolio of loans and a portfolio of high-yields," Holzenthaler added.

As to how firms are positioning themselves in the fixed-income market, Gretchen Lam, a Portfolio Manager at Octagon Credit Investors, said when constructing portfolios and managing risk, fund managers must balance the current income with the preservation of investments and convexity.

"Having the ability to invest both in loans as well as CLO debt and equity allows us to put a toggle on the margin between those two and take advantage of periods where maybe loans have traded off five points but CLO junior mezzanine tranches have traded off 10 or 15 or even more points," Lam explained.

And in today's challenging market, fund purveyors must decide whether they are trying to manage to a discount so that they are more attractive to a new investor or trying to manage to a premium to engender credibility.

According to Lam, "What we endeavor to do as a manager is to provide as much transparency as is physically possible so that the market has a clear a picture of the value of those assets and the income generating properties of the underlying assets in the fund."

"As a portfolio manager, ultimately you're tasked with the ability of going out with the investment thesis that you had and really capitalizing on that. I think the performance of the NAV will ultimately dictate whether there is a discount or premium, and consistency of NAV I think is a key point to be made there," Abghari added

Holzenthaler said in his view, the most attractive investment opportunities lay in more defensive sectors that are shorter duration and short on the curve.

"I don't necessarily think rates are headed higher but just the fact that risk premiums are very low so why not get paid to take that risk? A lower risk premium implies that future cash flows are discounted less, which would cause a price increase," Holzenthaler said.

He added that the same could be said about credit risk.

"My firm and my team manages below investment grade debt and we've been saying that being a little more defensive right now makes sense given that credit markets are pricing things in a way that is not in line with how you would think things would be priced during a global pandemic and a potential volatile presidential election in the US. There are many things that worry me and our team and it seems like the markets are shrugging those off for the most part. So, we've suggested clients get more defensive with their portfolios that we manage for them."

Navid Abghari, a Senior Portfolio Manager at Angel Oak Capital Advisors, agreed that the market has not performed as expected but it has created interesting investment opportunities.

"I think especially as we went through this COVID crisis, you saw the performance in various sectors become very different. Some areas, such as REITs and the preferred market, showed significant distress, and that could be a tactical opportunity that is very appealing if risk managed properly and timed correctly."

other conditions. Past performance is no guarantee for future results.