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Using CDS to exploit roll-down in IG credit can generate good returns even in a low-rate environment

In response to a low-rate world, fixed income investors are wont to go slumming in search of yield. High yield bonds and leveraged loans offer sufficient credit spread to offset the paltry or punitive rate component. They appear well suited to an accommodative environment, where easy refinancing mitigates concerns about debt service and keeps a check on default rates.

Indeed, even in the event of a default, leveraged loan investors have historically benefited from enhanced levels of seniority and concomitantly elevated recoveries.

However, since the financial crisis, tourists have turned high yield into an even sketchier neighbourhood. The market has seen an unabated erosion of underwriting quality such that generous add-backs to ebitda covenants conceal nose-bleed levels of underlying leverage, while liberal carve-outs for restricted payments and a free hand to move assets intracompany can materially dilute collateral. It is likely that 80% recovery on senior secured is a thing of the past, while recovery on second liens could struggle to get to 15%, and with diaphanous coverage of even minimal interest costs, these companies are vulnerable to economic downturns and exogenous shocks.

As we saw at the end of last year, financial market jitters can lead to a rapid shuttering of the HY new issue market, precisely when access is most needed. In addition, the aggressive colonisation of leveraged finance by index and algorithmic-based funds could precipitate a rout on bad news in a market that simply does not have the liquidity to deal with it.

Tourists have turned high yield into a sketchier neighbourhood… IG credit could be the answer

Repricing risk is high and rising

Even if investors get comfortable with credit and underwriting risk, repricing risk is significant. Sadly, at current spreads, investors are simply not being rewarded for it. Moody's estimates that US HY spreads need to be 100-150 basis points wider just to account for the uptick in the HY downgrade/upgrade ratio.

It might be wiser — and, on a risk-adjusted basis, more lucrative — to stay on the right side of the tracks. Investors' eyes glaze over at the mention of investment grade and, in terms of bonds, their reaction is justified; recent research from JP Morgan shows IG bond yields in the bottom quintile of their historical range. However, disaggregating the rate component and focusing on credit spreads presents an opportunity to access yield without compromising on quality.

Even at today's tight levels, investment grade credit spreads are still pricing in cumulative five-year default rates over five times the average realised level recorded between 1970 and 2018, and over twice the worst. In addition, relatively steep credit curves provide an opportunity to harvest an easy capital gain. Moving from the five-year to four-year position on the European investment grade credit curve generates an unlevered return of 0.56%.

Returns of 6% on investment grade assets

Applying typical high yield leverage to the combined running spread and roll-down gives a not-too-shabby one-year return of around 6% on an underlying portfolio of investment grade assets.

To disaggregate rate risk and access maturity points to exploit roll-down requires use of CDS. These can be leveraged on margin at zero cost; importantly, the investor controls the leverage rather than entrusting it to corporate managers, who can use debt to reward themselves or shareholders rather than boost the company's ability to generate free cash flow. (A feature of the post-financial crisis world has been the growth of 'zombie companies', which roll debt without ever generating sufficient cash flow to deleverage).

The ease with which CDS can be leveraged stems in part from their fungibility. The contracts are standardised (Isda) documents with none of the idiosyncrasies pertaining to coupons, covenants, call/put provisions, etc. that characterise cash bonds. As a result, they enjoy superior liquidity, which enables active managers to substitute underperforming credits and exit positions.

Even if exits entail losses, they are far from the mugging that investors will get for ditching an illiquid high yield bond. So, even in a low-rate world, creative plays on investment grade credit can allow investors to get their kicks without leaving the gated community.