Idiosyncratic Risks and Active Management

2019 has been a profitable year so far for High Yield investors. Euro spreads tightened from 522 bps in January to 367 at the end of September. Even if world central banks have created a dovish environment that helped markets to be more resilient to geopolitical events and economic slowdown indicators, high yield market has been characterized also by some major idiosyncratic risks.

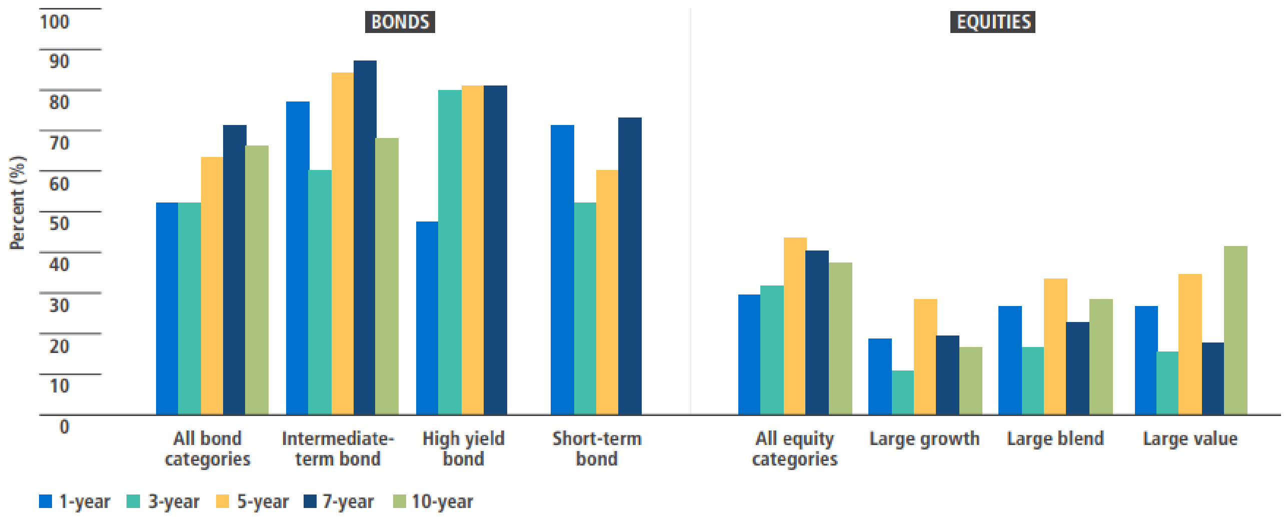
In fact, as the figure below shows, in the last months we have seen some defaults in the asset class.

Q1 - Q3 2019 - European High Yield defaults

Date of Default	Issuer	Sector	Reason
31/01/2019	New Look	Retail	Bankruptcy
09/04/2019	Debenhams	Retail	Bankruptcy
15/05/2019	New Look Senior Issuer	Retail	Bankruptcy
15/07/2019	Rallye	Retail	Restructuring
15/07/2019	Galapagos Holding	Manufacturing	Missed Interest
17/07/2019	Galapagos	Manufacturing	Missed Interest
23/09/2019	Thomas Cook	Travel Agency	Bankruptcy
25/09/2019	Lecta	Manufacturing	Restructuring

Thomas Cook is maybe the most remarkable one. The company was founded in 1841 and was one of the most known British global travel group. The once CCC rated company went bankrupt because was unable to secure a £200m from its bankers. However, problems started in 2007 with the disastrous merger of MyTravel Group (better known as Airtours and Going Places) and continued with the company lack of ability to be unable to compete against online booking companies.

Although defaults are rare and related to specific idiosyncratic risks, they create dispersion and opportunities that can active investor can catch. In fact, as the figure below shows, high yield bond active manager often outperformed their median passive peers. The same can't be said for equity asset class investors.

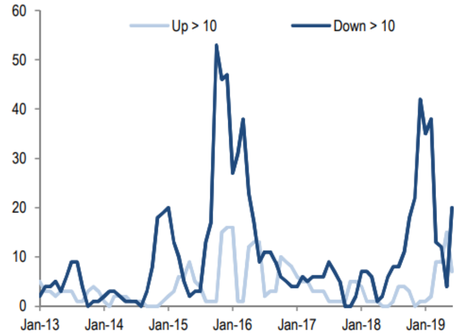


Source: Morningstar Direct as of 31 December 2016. **Past performance is not a guarantee or a reliable indicator of future results.**

Another reason we need to consider is regarding the broad high-yield market, which has limited institutional size trading that can't be replicated in the same way as the equity market. As a result, passive ETFs in the high-yield space try to replicate benchmarks that represent only the most liquid portion of broad-market high-yield indexes. In fact, passive investments, in particular in the HY segment, are exposed to the most liquid segment, which is often overvalued and subject to corrections.

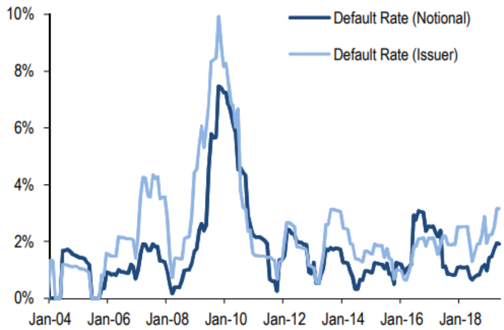
As a result, as the figures below show, the process just described creates high dispersion, however the default rates remain low in the Eur HY segment in particularly outside Manufacturing and Retail space.

Figure 65: No. High Yield Bonds Moving >10 Points per Month



Source: J.P. Morgan. Rolling 3 month total of rated euro and sterling high yield bonds.

Figure 69: European High Yield 12M Trailing Default Rate



Source: J.P. Morgan.

HY investors are currently facing a bipolar market, which we believe will tier in 2 even more in the next future: on one hand issuers that can borrow cheaply taking advantage of the low interest rate environment and on the other those, like Thomas Cook, who are under pressure carrying way too much debt given their business model.

We believe that a bottom up approach is fundamental to navigate HY markets in order to catch opportunities and sustainable yield in the asset class.