Stephen Fitzsimmons & Tim Leary

Episode 221: High Yield Bonds: A liquid complement to your alternative allotment

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name is Stewart Foley, I'll be your host. Thanks for joining us. We're thrilled to have you and we've got a great podcast for you today. The topic is high-yield Bonds, a liquid complement to your Alts portfolio, and we're joined today by Tim Leary, BlueBay senior portfolio manager at RBC, and Stephen Fitzsimmons, otherwise known as Fitz, institutional portfolio manager at RBC. Gentlemen, thanks for being on. Thanks for taking the time. I can't wait to hear and learn about this asset class today.

Tim: Great to be here, Stew.

Stephen: Yeah, cheers, Stew. We're happy to be here.

Stewart: Very good. Okay. So let's start them off like we always do. This one goes to you, Tim, where did you grow up and what was your first job?

Tim: One of my favorite questions. I grew up in Buffalo, New York, in the south side of the city in South Buffalo, and my first job would've probably been picking up garbage around the outside of my family's restaurant. When the snow melted, the spring came. So things like cigarette butts and things like that, that were left thrown out before people walked into the restaurant.

Stewart: Absolutely.

Tim: Yeah. My first job-job was actually working at a warehouse for a local store stacking empty bottles of Genesee beer that were to be returned back to be recycled.

Stewart: I love it. And, Fitz, how about you? Where'd you grow up? What was your first job?

Stephen: Yeah. So I very proudly grew up in Hartford, Connecticut, the insurance capital of the world, and my first job was just outside of Hartford in a little town called Newington, where I worked for my uncle at a company called Brampton Technologies. And what we specialized in and what they currently specialize into this day is grip adhesives in solvents for the broader golf industry. Their flagship product being something called HF-100, which stands for Hazard Free, that we were very excited to be able to ship all over the world for your golf gripping needs and epoxies and et cetera, et cetera.

I'd say my first job out of college, however, in an asset management was actually at the Hartford where I did a lot of investment operations and limited partnership accounting. And further to the topic of the meeting today, back in 2013 or so when I was at the Hartford and we're putting together a limited partnership contribution to NII or net investment income, we were always very excited to say we'd be on NII due to higher than expected LP income, which I think as exciting as that may or may not sound to you today, I think it's actually harder for some insurance companies to make that claim today. And that's a little bit of what we wanted to talk about, I think.

Stewart: Absolutely. I used to live in West Hartford and Simsbury, so I know that area well. I have some friends actually that are in Newington. There's a guy named Ray Zisa that has a place called the Corvette. It's the Corvette Center that's actually in Newington, so shout out to him.

Stephen: Nice.

Stewart: When you guys look out here, can you give us a little background on your career and how you got from... In one case, the warehouse to the seat that you're in today? Because managing money for insurance companies is often a place that people find themselves ending up in, but they might not have set out in that direction to begin with. So, Tim, give us a high-level overview of your background.

Tim: Sure, certainly. So I left Buffalo after high school, and I went to Fordham University in the Bronx. And after my freshman and sophomore year, I very vividly remember seeing a buddy of mine who was on the baseball team walking with a suit to class, and as I was chatting with him trying to figure out why he was all dressed up, he turns out he had had an internship at Northwestern Mutual, selling life insurance and doing financial planning.

And so as I was getting geared up to live in New York and graduate and get a job in finance, I majored in finance, and I was able to finagle an interview. I got the job, selling life insurance. It was an amazing experience as a junior in college to get licensed in life and health and learn about financial planning and actually pick up the phone and call people that were complete strangers who didn't want to buy a product that was very expensive that they only got to use when they were dead. But it was a terrific experience and I've learned a lot about the industry. And I actually through that process, met some folks that are on the Distress Trading Desk or were at the Distress Trading Desk at Credit Suisse who introduced me to somebody at Bear Stearns who was looking for a junior salesperson. And so I ended up on Wall Street through the side door, if you will, and started on the Leveraged Loan Desk at Bear Stearns in 2005 shortly after I graduated.

Stewart: Wow.

Tim: And that was a terrific experience as well.

Stewart: That's quite a move. That's a big move from being a Northwestern life agent to the Desk at Bear Stearns. That's a hell of a trade.

Tim: It was a great training ground. You learn to call people up and talk about things and how to understand certain things like the sale starts at, "No," but also to interact. And I said I intern with folks that are still at Northwestern Mutual and have done a fantastic job, and now I refer them around to my colleagues when they have babies and are in need of estate planning. And so I think it was a great life skill. I'm really, really proud of the time I spent there.

Stewart: Man, I started cold calling. I was at Merrill Lynch and then at Paine Webber dating myself. But yeah, I did a lot of cold calling too. A bunch of it. And it is character building, I'll tell you that. How about you, Fitz? Tell me a little bit about you before we get going here on the topic.

Stephen: Yeah. Actually, I can relate to all of that a little bit. During my undergraduate experience at UConn, I had an internship where I got my series 7 and series 63, and I was cold calling retail clients to come in and invest at the bank, and it was one of the more formative experiences of my life, I think. At the time it was very difficult work, but it taught me a lot about just how important the topics of financial concerns and financial psychology are to individuals. And it taught me a lot about how to take something that's rather intangible, such as finance and portfolio management, what have you, and explain it into a way to people that don't live and eat and breathe this stuff the way all of us do in a way that is more tangible and understandable, comprehensible, something that they can take home and really understand.

But really for me, I wanted to get into institutional asset management, and as I looked at the opportunity set in the Hartford area, one, it was insurance companies, and two, it was fixed income. So toward the end of my undergraduate studies, I came to the realization that there really weren't teaching a lot about bonds in undergrad. You do maybe one class on money and banking, and there might be a chapter about fixed income, but it seemed as I dug under the hood a little bit that it was a super broad, super liquid market that impacts our daily lives in ways that most people don't really think about. Like any credit card, any mortgage, any loan, you go shopping, if you're going down the street, you see companies that you lend money to. It just touches every corner of our society.

So if you combine the opportunity, I set what had within the Hartford area with what I was learning about fixed income and being super interesting, insurance asset management was something that really attracted me early on, and that's what got me in the door in institutional asset management. And that path led me to Conning where I was an APM and then a more senior PM role. And I know you were ex-NEAM, Stew, and I think it's like the beginning of a really unfunny joke would be an ex-NEAM guy and an ex-Conning guy walking into a bar.

Stewart: Exactly. But you know what I mean, in all sincerity, and I taught for a number of years, and fixed income isn't taught, even today. And people, I go, "Hey, listen, the market's twice as big as the equity market." And by the way, every time you swipe a little card in your hand, that ends up in one of our deals someplace. And every time somebody buys a car that ends up in a deal someplace. And every time somebody buys a house that ends up in a deal someplace. And it's like a lot of college kids do not understand or have not been exposed to what I believe.

And I'm a fixed income geek through and through. I love fixed income. I think it's an awesome asset class. There's such great diversity in it. And the purpose of today's call is to talk about high-yield. And so I'm not a high-yield person, but I do know from past experience that the spreads on public credit are on the tight end, but on an absolute value are higher than they have been in quite some time. So can you talk a little bit about the total return outlook and relative value in high-yield, which is where you're both focused at BlueBay and RBC?

Tim: Sure. So I've spent my entire career as a full-time employee, other than the short period of time I was an intern on the fixed income side. I started in Leveraged Finance at Bear Stearns on the loan desk, which was on the private side at the time, primarily beside the high-yield bond desk. And then when Bear closed, I went to the Royal Bank of Scotland with many of the members of the team. And two months after that, we were trading distressed Lehman bonds on the desk. Lehman had filed for bankruptcy. And so if you think about where we are in the spectrum of performing credit markets versus non-performing credits, the point being that we've seen a few things over the years and the reason spreads are tight now and you're 100% right, is the fact that the balance sheets for many of the issuers are in really, really good shape.

And what do I mean by that? It means that the likelihood of default is low. It means that companies can afford to service their debt, which means they can pay the interest when it's due. There's very little in the way of maturity walls or bills that are coming due that need to be refinanced as an example. And so that's the reason why interest rates are spread tight and now the reason yields are higher is because interest rates are higher. And so part of the allure of the high-yield market and credit markets in general is the fact that you've got this opportunity where you're at a point in the cycle, where as you start to see slowing of the economy, you're at a great intersection between performing companies that are going to be able to weather a slowdown and then have the added bonus of a duration tailwind where you can see fixed income assets start to come back in the boat.

Stewart: That's great. Thanks, Tim. Fitz, can you bring this back from an insurance perspective a little bit?

Stephen: Yeah, of course, Stew, and as Tim said, of course, as you look at the OAS of the US High Yield Index right now, spreads look fairly snug. But as you think about how you go about optimizing insurance portfolios, a big thing that you think about is spread per unit of duration. And if you were to compare the duration of the High Yield Index to maybe some broader US IG indices, maybe the AG, the duration on the US High Yield Index is closer to a three zip code we'll say. And the OAS relatively on a normal basis, tight at maybe 310, 315 bips.

If you were to take that though and put a spread per unit of duration on that, that's the ballpark of 100 basis points. If you were to go back to 2019 and compare that level spread per unit of duration, that's actually pretty close to fair value, pretty close to what you would expect to see in terms of averages over that time period. And the yield on the index right now is right about 8% or thereabouts, we would say. So yield per unit of duration, which I think is another important metric when you're optimizing insurance portfolios, is about 2.5%. And going back to 2019, the average is about 2%, I would say. So on a nominal basis, you're looking in the ballpark of being 50 bips cheap on a yield perspective, which we think offers some pretty interesting value to insurers right now.

Stewart: That's an interesting way to look at it. That is a really interesting way to think about it. So I want to invite you to dust off your professor-for-a-day hat, which by the way is technically known as a Tam or a Mortarboard, but tell unpack what OAS means for our audience that might not know. And you mentioned bips. I know a lot of us fixed income folks know what that means, but can you unpack bips for us as well?

Stephen: Sure. So OAS would be option-adjusted spread. So that's the spread above your nominal treasury to be compensated for buying the risk inherent in any type of credit product that is adjusted for any call features or whatever you might have on the bond. It refreshed me, my memory, what was the other element to that?

Stewart: And bips, which is short form for basis points. Some people call say, "bips," some people say, "bips," but at the end of the day, it is 1/100th of a percentage point, which means that 100 bips is 1%.

Stephen: That's right.

Stewart: So when people in fixed income talk about spread and OAS, we're always talking about whole numbers, but those are whole numbers of basis points for the most part. That's instead of saying 0.67%, we would say 67 bips.

Stephen: Right. Totally.

Stewart: Just a little bit like, "Hey, if we're going to get our fixed income geekness on, we got to start there too."

Stephen: Yeah. We definitely have to make some definitions here.

Stewart: Absolutely.

Stephen: One other small point I wanted to make on that, if you were to look at the Risk-Based Capital C1 charges for life insurers, particularly across the stack, but particularly within high-yield. So this will say RBC C1 as an acronym moving forward on this topic. But I think you could look back to 2020 before recent changes from the Academy of Actuaries and the NAIC came through changing how we look at the individual credit quality buckets and tiering of how we do charges in terms of RBC for life insurers. We went from 6 buckets to a much more granular 20 buckets. And although if you actually looked at the before and after and weighted against the index back in 2020 before the changes versus where the index is at now, the overall impact on capital charges of owning every cash bond in the index is actually very minimal.

It was about 9.3% if you were to buy the index versus 9.3% and a little bit of change after in terms of your weighted average RBC charge. But what's interesting, if you took this one step further from spread per unit of duration or yield per unit of duration, what if we looked at yield per unit of RBC? So before the C1 changes back in 2021, so if you look at the end of 2020, the index was at about 45 bips of yield per unit of RBC across the US high-yield space, whereas now we're looking at about 85 bips per unit of RBC now.

To me, this illustrates another 40 bips of pickup in terms of where we were back then before the charges and where we are now. And if you think about what happened before and after the charges, there was a fairly material move from high-yield assets, public fixed income in general, but high-yield specifically into things like alternatives, limited partnerships in private credit. So we actually see a bit more value there as well. If you look at things on that basis, which is really important to our insurance clients.

Stewart: And just for everybody's information, RBC stands for Risk-Based Capital, and there's a charge based on the rating provided by an NRSRO, and that corresponds to a capital haircut, and it goes up as risk goes up, capital charges go up and you're referring to the yield per unit of capital charge. And it's interesting that you quoted 40 basis points, but that's off of a basis of 45. So in percentage terms, it's nearly double what it was at that time. So again, I think that's an interesting way to measure relative value. So let's talk a little bit about fundamental outlook for high-yield versus other sectors and what fundamental value looks like. So do you want to take that, Tim?

Tim: Sure. Thanks, Stew. So I think one of the biggest misconceptions about the high-yield market and in corporate bonds in general is that investment grade corporates are free from risk. The fact of the matter is about 50% of the US IG market, investment grade corporate bond market is triple B rated. Would you be surprised to know that just over 50% of the US high-yield market is double B rated? And oftentimes the difference between that rating of invest low triple B and high double B is purely the size of the company. And so high-yield issuers, of which there are about in the high 800 at the index level across 1800 or so different bonds that you can choose from. A little over half of those are WB rated and are very, very unlikely to default.

The market has changed dramatically from the period of time we see now post-COVID where companies have termed out their balance sheets and the coast is clear with regard to the refinancing needs, but the actual fundamentals have improved for a number of reasons, not the least of which has been inflation has been really helpful to many of these companies. They effectively charge their clients more, whether it's goods or services, but the amount of debt they have outstanding stays the same. And obviously I'm simplifying. And their cost, their debt service is very little change because they've locked in these low interest rates on these corporate bonds that now trade at a discount. The discount is depending on which subset of the index you're looking at, somewhere between 5 and 7 cents to par, meaning you can buy something below 100 cents on the dollar and get 100 cents on the dollar back plus interest.

And that's part of what's driving that OAS. So you've got a mix of higher coupon, high dividend paying pieces of debt instruments that are very liquid coupled with low dollar price bonds that are trading at a discount. And so that combination gets to that OAS. The fundamentals are certainly strong, stronger than they were in various points heading into a recession. If you're of the view that you're having in recession, you're in a pretty good place from a balance sheet perspective. But I did want to draw that point of order so to speak, and this is not your father's junk bond market.

Stewart: That's super helpful. And so, Fitz, I just want to talk a little bit about the importance of liquidity. Insurance companies, there's times when the wind blows, and hail falls out of the sky and they need money. And so can you talk a little bit about the liquidity in the high-yield bond market today and maybe put it in historical context if possible.

Stephen: Yeah. I think further to the theme that this is not your father's high-yield bond market that Tim alluded to just now, the market has increased in terms of understanding across investor base, across adoption amongst different types of investors in the space. It's increased in size materially over the years, and it's become extremely liquid to the point where you could have daily liquidity in any strategy that we're running here in terms of public leveraged finance. And further to that, our strategies, we tend to focus on an opportunity set of names to the tune of 120, 140 names, something in that ballpark versus the 800 plus that Tim just quoted in the index. What that allows us to do is really select the most liquid names that present value within the index itself, within our opportunity set. Tim, I don't know if you want to piggyback off of that a little bit.

Tim: Sure. The size of the market has grown over the last 10 years. It's actually not as large as it was notionally a year ago because there's been bonds that have been upgraded to investment grade and left and more bonds have been upgraded than downgraded. And so the rising stars compared to fallen angels has actually led to the market shrinking a little bit. The largest reason that the quality of the index has improved in those larger liquid and CUSIP having tradable bonds is that private debt and leverage loans have refinanced or been the use of capital for a lot of the LBOs have come. And so pendulum has swung away from the fixed side of the market into floating rate in private markets. The net effect of which is that you're left with a higher quality, more liquid cohort of bonds and that's certainly helpful.

The second part that's really improved liquidity is the concept, and this is more of a technological advance, is the portfolio trading. So when I started at BlueBay in January 2012, I ran trading for North America. And at the time if you wanted to trade a strip of your portfolio either to buy or sell, you had to do that manually. Now, I can call up two dealers or our trader can call up two dealers and transact anywhere between $20 to $750 million of a portfolio in one, putting dealers in comp and having that transact and dealers on the other side turn around and hedge it using derivatives or HIG or whatever balance sheet they can to while they get out of the risk. It's incredible. It's actually profitable for the dealers and it improves liquidity for investors from insurance companies to institutions to retail alike.

Stephen: And so as we think about what this means for insurance companies that may be thinking about engaging with the space - as you well know, Stew, from your experience, insurers have a limited amount of risk capital that they can allocate to a nearly limitless set of opportunities. And over the past decade or so, I would say we've seen through one means or another a material consolidation within life insurers specifically, and property casualty as well to a lesser extent where you have large BDCs or private equity coming in and becoming strategic partners with different types of insurance companies and as insurers through this low yield environment that we've had up until about 2022. So a very long protracted period of low yields they've had to get creative and with what tried to find that next incremental bit of net investment income.

What I've noticed over the past, I don't know, three or four years or so, is a return of competitiveness in terms of the yield offered on broad public fixed income and specifically high-yield where we think as insurers are striking strategic asset allocations with more and more alternative types of assets that may have a longer ramp time, that offer a very admittedly attractive, less correlated return stream to broader fixed income. The long ramp and the liquidity that you sell, we think, can be complemented by the high-yield market. And that's where we're getting at in terms of the importance of liquidity. And the types of consolidations that we're seeing is it's not just legal entities merging into each other, we're also seeing more reinsurance agreements being struck where insurers have to encumber large portions of their portfolios to satisfy different elements of the reinsurance agreement where that's a funds withheld agreement, whether that's a comfort trust.

And what that does is it creates a situation where certain assets are tied up in case there's a recapture event and the insurance company comes under some element of stress. We think liquid bonds are a very obvious and nice complement to your alternative portfolio in that type of situation. And you could be nimble about novating public bonds from one legal entity or one reinsurance agreement to another. And we think high-yield has the added benefit of offering a similar type of total return possibility as your Alts bucket, which is really where we're coming at in terms of this particular conversation.

Tim: Yeah. I would say just to add to that, you get Alts like total return prospects depending on your investment horizon and your view on duration for a liquid cohort of the market that you can be more tactical in. And so just given the breadth and the number of bonds in the benchmark at different ratings bonds, creating customized portfolios for institutional clients is at the heart of what we do, whether they're pension funds or insurance companies. We manage over, what are we up to over $18 billion now of InsuranceAUM, Fitz.

Stephen: That's right.

Tim: And the nice part, what's the most exciting about it for me and Fitz is that we get to have this conversation now with folks in the United States; primarily our roots are in London and Canada, and now we get to go spread the word in the US of A.

Stewart: And that is absolutely what we're all about doing right now today. So I've gotten a tremendous education and on the high-yield bond market, and I appreciate you both being on. I've got a couple of fun ones for you out the door, there's two of you. So we have to go quick. What's a piece of advice that you would give your 21-year-old self or someone who's newer in this industry, what would you say to them that you think would be helpful? Fitz, I'll start with you.

Stephen: I think as a younger professional, it's easy to operate with a degree of ambition, and I think that's healthy, but what can get lost in the shuffle shortly after university as you're trying to make your way through your career is the importance of patience. And one of my mentors in my past has always told me to measure twice and cut once, and sometimes I think I need to measure 20 times before I cut. But I think being patient is something that you don't hear enough as a younger person, and if you do hear it, you tend to say, "Oh, that's ridiculous. What are they talking about? I have no time for patience, but I actually think it's really important in managing career."

Stewart: Very cool. How about you, Tim?

Tim: Yeah. The single greatest piece of advice that I've ever gotten, and it came from my dad, and he made sure he is like, "Don't get too up on the ups or down on the downs." And what he means by that is really just finding a way to stay positive and stay level. There's going to be periods of volatility in your professional career. There's going to be times when you walk in and Bear Stearns closes. There's going to be times when things are challenging, but being able to stay positive and keep moving the ball forward is the name of the game and that your vibe is going to attract your tribe.

And we have that group of people and our team here in BlueBay, which is why we have so little turnover, which is why we've been able to grow and be successful the way we are. It's very much a solid work-life balance that when times are tough, you are pulling together and when times are great, you're out celebrating together. And it's a great way to go about life because there will be peaks and valleys and just to keep moving the ball forward.

Stewart: I love that. That's great advice. All right. So the last one goes like this. You can invite three people a lunch, alive or dead. You each get one and you got to agree on one. How about that? So how about you? We'll start with Fitz last time. Tim, I'll start with you. We're going to have lunch. It's you and Fitz. You get invite three guests, you get one, he gets one, and you got to agree on one. Who's yours?

Tim: Great question. My 10-year-old and his buddies asked, we were playing this game on the way back from lacrosse tournament two weeks ago, and I think-

Stewart: Prepping for the podcast. Good job.

Tim: Exactly. Exactly. I think we were up at West Point watching a game, and I think Robin Williams was my answer then. I think he's one of the most interesting human beings ever. And I think that he would be a great guy to have lunch with.

Stewart: That's awesome. How about you, Fitz?

Stephen: None other than Matt Bellamy, the lead singer and guitarist for Muse would be mine.

Stewart: Wow. There you go. How about the one you guys are agreeing on?

Stephen: Andre Skiba.

Stewart: Who's that?

Tim: Too funny.

Stephen: He's the head of U.S. Fixed Income - that was half kidding.

Tim: I'm going to give Fitz a softball here. We're going to say his new fiance that he keeps threatening to bring to the office.

Stewart: Wow-

Stephen: There we go-

Stewart: ... all right. There we go.

Stephen: ... and introduce the team.

Stewart: Wow.

Tim: Isabelle is coming to lunch.

Stewart: All right. There we go.

Stephen: There you go. Done and done.

Stewart: Perfect. I love it. Thanks for being on, guys. This has been a fun conversation. I love it. We've been joined by Tim Leary, who's the BlueBay senior portfolio manager at RBC and Stephen Fitzsimmons, otherwise known as Fitz, institutional portfolio manager at RBC. Guys, thanks for being on.
Stephen: Thanks for having us.

Tim: Thank you, Stew. Thank you so much.

Stewart: Had a lot of fun. Thanks for listening. If you have ideas for podcasts, please shoot me a note. It's Stewart and InsuranceAUM.com. You can rate us, like us, and review us on Apple Podcast, Spotify, Google Play, Amazon, or wherever you listen to your favorite shows. My name's Stewart Foley. We look forward to hearing from you next time. This is the InsuranceAUM.com podcast.