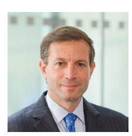
BARINGS

PUBLIC FIXED INCOME

The Case for Investing in Senior Secured Bonds

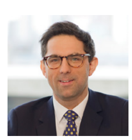
INSIGHTS

From capital structure seniority and high historical recovery rates, to lower interest rate sensitivity and compelling yields, global senior secured bonds offer a number of potential advantages.



Craig Abouchar, CFA
Managing Director, European High Yield

Kelly Burton
Managing Director, U.S. High Yield



Chris Ellis
Director, European High Yield

Why Senior Secured Bonds?

The global senior secured bond market is a sizable sub-component of the broader global high yield bond asset class and, as the name indicates, comprises bonds that are senior and secured in the capital structure. Senior secured bonds reside at the top of a company's capital structure, ranking first in line for repayment in priority over other liabilities and shareholder interests. They also benefit from security interests in various firm assets, which can include tangible assets—such as property, plant and equipment, inventory and contractual claims—as well as intangible items like software and trademarks. Ultimately, this means that if a company defaults on its debt obligations, senior secured bondholders are first in line for any repayments, in priority over other creditors, and also stand to benefit from their control (via the security interests) in the assets that are critical for running the business.

As a result, senior secured bonds have historically offered higher recovery rates than unsecured bonds. For example, from 1987 to 2021, the average recovery rate for defaulted senior secured bonds was 61.5%, compared to 47.4% for senior unsecured bonds and 27.9% for subordinated debt.[1] The success of the senior secured bond market has been such that over the past five years it has increased in size by roughly 70% to over US$500 billion, equivalent to about one third of the global high yield bond market.[2] This is a broad, deep and well-diversified market that provides ample options for an active global high yield manager, with a rich opportunity set to generate sustainable alpha.

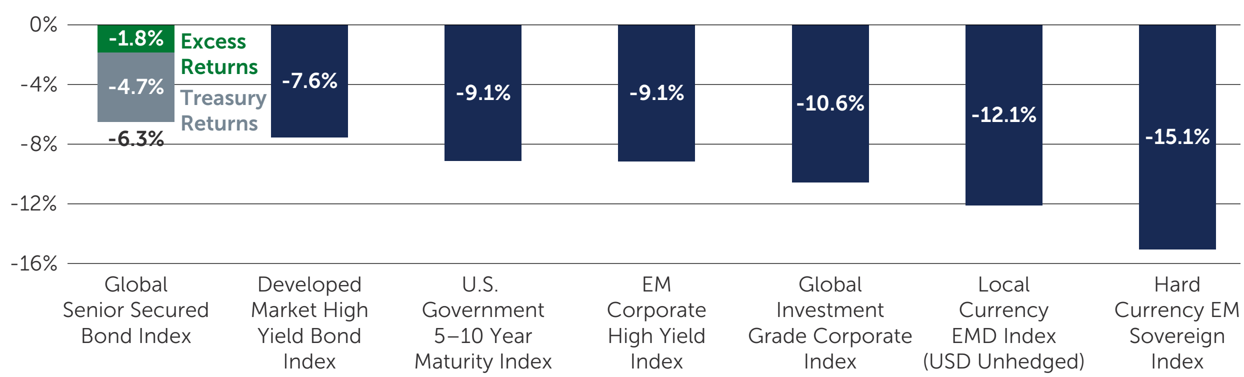
Why Now?

NAVIGATING A CHALLENGING ENVIRONMENT

It has been an extremely challenging and volatile period for most financial markets this year, driven by elevated inflationary pressures, hawkish central bank activity with expectations of rising interest rates and tightening financial conditions, geopolitical tensions with Russia's invasion of Ukraine, and the ongoing disruption from COVID-19, particularly in key regions such as China. Like other segments of the global fixed income markets, senior secured bonds have not been immune from the pressure stemming from the rise in government bond yields around the world.

Of note, however, senior secured bonds have outperformed most other global bond markets year to date. This is largely due to the asset class' shorter duration profile (a measure of interest rate sensitivity) and high coupon levels, which have created an attractive alternative to the higher-quality, more interest rate sensitive segments of fixed income **(Figure 1)**.

Figure 1: Year-to-Date Returns Across Fixed Income Asset Classes



Source: Barings, ICE BofA Non-Financial Developed Markets High Yield Constrained Index, JPM CEMBI BD Non-Investment Grade Index, ICE BofA BB-B Global High Yield Secured Bond Index, ICE BofA Global Corporate Index, JPM U.S. Government Bond Index, JPM EMBI GD Index, JPM GBI-EM GD Index. As of April 30, 2022. Returns in USD hedged terms unless stated otherwise. The grey shaded bar represents returns attributable to the Treasury component of the market whereas the green shaded bar above represents Excess Returns attributable to the Credit component. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

1. Source: Moody's Investors Services Annual Default Study. As of February 8, 2022.
2. Source: ICE BofA BB-B Global High Yield Secured Bond Index, ICE BofA Non-Financial Developed Markets High Yield Constrained Index. As of April 30, 2022.

Over the past decade, we have observed a similar trend, with senior secured bonds demonstrating lower volatility and downside market capture versus broader credit markets in periods of elevated market stress, such as during the 2015 commodity crisis and the market sell-off in the fourth quarter of 2018.

So far, 2022 has proven to be a highly unusual environment for global credit markets. Over the last decade, most periods of negative returns in credit markets could be attributed to a combination of deteriorating fundamentals and increasing risk aversion, which drove credit spreads wider. This time around, credit fundamentals have remained strong—but as developed markets are being ravaged by inflation for the first time in almost 40 years, we have seen historically significant increases in government bond yields, which have driven prices lower across all segments of fixed income. In fact, the rise in government bond yields during the first four months of the year **(Figure 2)** was so sharp and severe that it could not be offset by interest income. Following the U.S. Federal Reserve's (Fed) decision in early May to raise interest rates by 50 basis points (bps), the market was still pricing in an additional 2.2% of rate hikes, or a policy rate of over 3%, over the next one year.

Against this backdrop, it is worth noting that senior secured bonds tend to have lower interest rate sensitivity—as measured by modified duration to worst—than other asset classes. For example, senior secured bonds currently have a duration of 4.0 years, compared to a duration of 4.4 years for the broader high yield market and 6.6 years for investment grade credit.[3]

Figure 2: Government Bond Yields Rose Sharply Through April

	5-Year Government Bonds			
	Sep-21	Dec-21	Mar-22	Apr-22
U.S.	0.97	1.26	2.42	2.92
Germany	-0.56	-0.45	0.38	0.68
U.K.	0.64	0.82	1.41	1.67

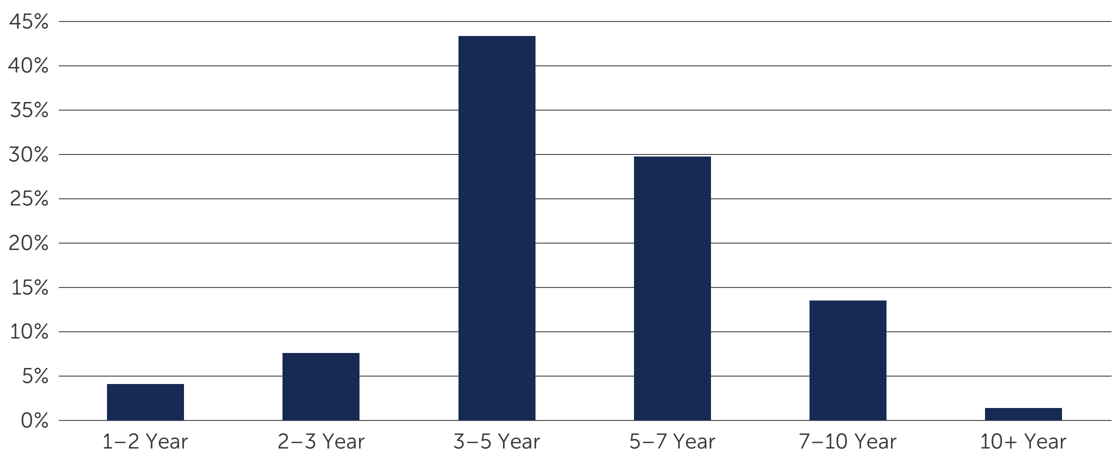
Source: Bloomberg. As of April 30, 2022.

3. Source: ICE BofA Non-Financial Developed Markets High Yield Constrained Index, ICE BofA Global Corporate Index. As of April 30, 2022.

Company Fundamentals Remain Resilient

While credit spreads (a measure of default risk) within the senior secured bond market have widened on a year-to-date basis, driven in part by heightened macroeconomic uncertainty, the widening has occurred against a backdrop of relatively resilient credit fundamentals. Company financials have improved considerably following the initial COVID-19 induced shock in 2020, with leverage levels and debt service costs decreasing materially. Further, given the record amounts of new bond issuance in the senior secured bond space and across broader credit markets over the past two years, issuers have been able to raise ample liquidity buffers and push out debt maturity walls. As a result, default rates remain muted and near-term solvency risks look to be relatively well-contained.

Figure 3: There is a Limited Number of Bonds Maturing Over the Next Three Years



Source: ICE BofA BB-B Global High Yield Secured Bond Index. As of April 30, 2022.

While inflationary pressures continue to build, companies have generally been able to pass on increased input costs to their end customers. This is partly due to the strong financial position of developed market households amid high savings rates through the pandemic, as well as rising wages in response to tight labor markets. Pent up consumer demand across specific market segments is another contributor, and has remained robust as economies emerge from COVID-related lockdowns and restrictions. Even in some of the sectors hit hardest by the pandemic, a number of companies look well-positioned to benefit from the ongoing reopening across developed markets; travel and leisure companies, for instance, have been performing relatively well in recent periods.

That said, rigorous due diligence and active management is critical in the current market environment. As we look at the market today, we believe there is a case for reducing exposure to issuers that are more susceptible to a weaker economic backdrop, especially where spreads do not appear to be compensating investors accordingly. We are also cautious on companies whose business models are more likely to experience adverse effects from increasing inflationary pressures or supply chain disruptions.

Significant Re-Pricing Has Created Select Opportunities

As a result of the sharp move higher in bond yields, driven largely by rising government bond yields but also, more recently, from widening credit spreads, the senior secured bond market is trading at a considerable discount to par. At the start of the year, the average bond in the market was trading at a premium price—around 101.4—compared to the face value of 100 per bond. Today, because of the increase in yields, we have seen a significant decline, to a discounted price of 90.9.[4]

Following these price declines, the yield-to-worst for the senior secured bond market has increased by over 3% year to date, and is now approaching 8% **(Figure 4)**. The combination of higher yields with materially discounted bond prices is an ideal environment in which to drive attractive total returns. Indeed, the overall price dislocations have created compelling opportunities given the relatively higher yield levels on offer, as well as the potential total return opportunities for securities that will eventually migrate back toward par value over time.

Figure 4: The Yield-to-Worst for the Senior Secured Bond Market has Increased by Over 3% YTD

	Global Senior Secured Bond Market				
	Dec-18	Dec-19	Dec-20	Dec-21	13 May-22
Yield to Worst (%)	7.06	4.96	4.34	4.59	7.69
Price	95.6	102.6	103.9	101.4	90.9

Source: ICE BofA BB-B Global High Yield Secured Bond Index. As of May 13, 2022.

To put valuations into some context, current credit spreads for senior secured bonds are broadly in line with levels observed during the fourth quarter of 2018, a period characterized by rising concerns that Fed policies could result in tightening financial conditions. What is different—and more beneficial—today, however, is that the price of the average bond is over four points lower than the comparable period at the end of 2018. This is against a backdrop of relatively sound credit fundamentals and record low default levels, which should offer some added comfort in a slowing-growth environment.

> *"The combination of higher yields with materially discounted bond prices is an ideal environment in which to drive attractive total returns."*

4. Source: ICE BofA BB-B Global High Yield Secured Bond Index. As of May 13, 2022.

Looking across a longer time horizon, since the Global Financial Crisis there have been three distinct periods where yield-to-worst levels for the senior secured bond market have exceeded 8%. In all of these periods, the 12-month forward returns from the time yields first exceed 8% levels has been quite strong **(Figure 5)**.

Figure 5: 12-Month Forward Returns When Yields Have Exceeded 8%

Date	12-Month Forward Returns
5 August 2011	10.3%
13 January 2016	14.8%
12 March 2020	14.0%

Source: Barings, ICE BofA BB-B Global High Yield Secured Bond Index. As of May 13, 2022. Returns in USD Hedged terms. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS

Key Takeaway

As we look across the markets today, and given some of the significant re-pricing that we have observed thus far in 2022[5], we believe senior secured bonds offer an interesting investment opportunity for a number of reasons:

- Relative to most fixed income markets, senior secured bonds have a relatively lower interest rate sensitivity profile
- Despite corporate fundamentals remaining relatively resilient, senior secured bond yields are approaching 8% with bonds trading at around 10% discount levels, offering attractive return prospects
- Seniority in the capital structure may be preferred in an environment of heightened uncertainty and slowing growth

There is no shortage of risk factors to watch going forward. The long-term impacts of the Russia-Ukraine war are impossible to quantify at this stage, and have created considerable levels of uncertainty across markets. Further, aggressive monetary policy tightening and elevated inflationary pressures may continue to weigh on market sentiment and drive market volatility.

But it's important to note that periods of volatility can—and often do—result in opportunities for active, bottom-up managers to generate alpha. This has been the case through multiple market events, from the sovereign debt crisis, to the commodity crisis, to the COVID-19 selloff. However, through these ups and downs, vigilance is key. If the past is any indication, a steadfast focus on fundamentals and bottom-up, credit-by-credit analysis can help identify issuers with the potential to thrive beyond today's events.

5. As of May 2022.

Why Barings?

Barings has been an early investor in global senior secured bonds. With a more than 11-year dedicated track record, we have managed investments on behalf of our clients through the ups and downs of multiple credit and economic cycles. And importantly, we have done so with consistency.

A key contributor to our performance over time is our large global team. One of the industry's largest, our high yield platform comprises more than 60 dedicated U.S. and European high yield investment professionals.[6] In keeping with our size and global presence, our senior secured bond strategy offers well-diversified geographical exposure across Europe and North America, with allocations of 42% and 55%, respectively.[7] With expertise and on-the-ground investment resources across multiple regions, we are uniquely positioned to assess relative value opportunities, especially given that large and well-established companies in the market typically issue debt across multiple currencies.

This local presence across markets is particularly beneficial during periods of elevated short-term interest rate differentials, when foreign exchange hedging costs can have a material impact. For example, based on current market expectations for U.S. dollar rates to rise meaningfully faster than European rates, there is typically a greater pick-up from hedging foreign exposure from the Euro back into U.S. dollars, which can provide additional relative value opportunities versus single region focused strategies.

In light of the recent developments in Russia-Ukraine, it is important to note that our senior secured bond strategy is principally focused on developed market issuers. Understanding insolvency/bankruptcy laws and how they may be applied to each issue is a key component of our analysis. Well-established legal systems, with decades of precedent in which to rely upon, allows us to undertake these structural reviews with a much higher degree of certainty.

Another benefit of our high yield platform is our ability to collaborate with our Capital Solutions group, which helps us maximize recovery values in the event of a credit impairment. Our scale allows us to conduct detailed, bottom-up analysis of company financials, integrate environmental, social and governance factors into our credit assessment, and to actively engage with company management to identify attractive opportunities. Given the market uncertainties at play, we continue to manage our senior secured bond strategy in a highly active manner, with a strong emphasis on bottom-up security selection. Ultimately, when it comes to mitigating credit risk and uncovering relative value opportunities, we believe analyzing the underlying credit fundamentals is paramount.

6. Source: Barings. As of April 30, 2022.
7. Source: Barings. As of April 30, 2022.

Barings is a US$371+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

LEARN MORE AT BARINGS.COM

**As of March 31, 2022*

22-2226148