

National Post

Low default risk in high-yield bonds; Corporate debt may return 13% to 15% over next year

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Byline: Jonathan Ratner

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Illustrations: Color Photo: Brett Gundlock, National Post Files / Ben Cheng, manager of the IA Clarington Tactical Income Fund, has reduced his cash weighting to 15% from 30% to 40% last year. The high-yield corporate bond market still looks attractive even though spreads have narrowed, he says.

Manager: Ben Cheng, Aston Hill Financial Ltd.

Fund: IA Clarington Tactical Income Fund

Description: Reversed balanced fund (bonds and equities), focus on generating high level of cash income

Fund size: \$425-million

Aston Hill's mandates: \$1.1-billion

Style & Process: Growth at a reasonable price (GARP) with an emphasis on value

Current asset mix: 50% bonds and preferred shares, 35% equities, 15% cash

Nervous about many things he saw last year, Ben Cheng, Aston Hill Financial Ltd.'s president and chief investment officer, typically had cash positions between 30% and 40%. However, things began to change considerably in the first half of 2009. In February, the portfolio manager began bringing those cash levels down to the point where they were just 5% in June.

Since then, Cheng has increased the fund's cash position to about 15% but not because of any concerns relating to fundamentals. Rather, he became uncomfortable with valuations given how far the market had gone in such a short amount of time.

"There is no V-shaped recovery, I think the market has come to that full realization," says Cheng. "But there is going to be a recovery nonetheless, and I don't think investors should take their eyes off of that particular view."

Since the recovery will likely be a slow one, the rebound in earnings for most equities will be good, but not extremely robust, the manager says. As a result, he is comfortable investing in bonds that offer potential returns of 15% and suffer much less volatility than the equity market.

From a risk-return framework, Cheng says the high-yield corporate bond market continues to look attractive even though spreads have narrowed by about 10%.

"When spreads got to well over 2000 basis points

back in December, it essentially tripped a bunch of our models and we decided to start pushing a greater percentage of the fund into it," he says, explaining how the portfolio went from about 30% in high-yield bonds and preferred shares in December to about 60% by the end of March.

"I think that nominal yields for high-yield bonds today -- considering that default rates will probably be much lower than most people expect -- should be somewhere in the neighbourhood of 10% or 11%," says Cheng. "So the returns are not going to be as generous as what we've seen in the recent past."

Nonetheless, he expects returns for the next 12 months could be in the 13% to 15% range -- not bad at all considering that the global and U. S. economy could be in a very slow growth pattern.

Cheng's biggest economic concern is job losses. If the U. S. continues to lose 500,000 jobs each month, it will be "horrid" for the U. S. and global economy.

However, the manager says that like inventories, we are in what he calls a "just-in-time" jobs market. Employers look at the sudden and sharp recession and are not willing to hang on to their workforce in hope of a better day, says Cheng. So instead of cutting 5% of their staff, they cut 15% or 25%. The upside, the manager explains, is that companies have set themselves up for less attrition later.

"The bulk of the pain in the jobs market is being felt as we speak, which points to a better jobs market in the second half of 2009 as well."

Nonetheless, with economic numbers in the next six months expected to look less ominous because the hurdle rate has moved down, Cheng feels we are in the last stage before returning to an economy that is creating jobs. However, he says 150,000 U. S. jobs need to be created each month just to stand still -- a far cry from where we are now.

jratner@nationalpost.com-----

BUYS

CRESCENT POINT ENERGY CORP. (CPG/ TSX).

Cheng added to this long-term holding during the downturn in December, which points to the portfolio's increased focus on oil versus natural gas.

Gas prices could fall further this summer, which could be devastating to a lot of Canadian gas players, Cheng says. He doesn't see oil much below US\$60 per barrel in 2009. In fact, he expects crude will be in the US\$70 to US\$80 range for 2010, which means Crescent Point's dividend is safe.

The company recently converted to a corporation from an income trust but will continue to pay a 23¢ monthly dividend. The manager notes that the company's tax-loss carry forward also means it stands a good chance of sustaining its current payout.

OPTI CANADA INC. bonds (8.25%, Dec. 15, 2014).

Trading at a yield of about 19% and roughly 60¢ on the dollar, Cheng bought these bonds through the end of 2008 at less than 50¢ on the dollar.

OPTI has been the subject controversy recently after the TSX blocked the company's attempt to do a marketed deal because the offer price was more than 20% below the stock's average trading price over the past five days.

While the share price movement is understandable given the uncertainty related to the equity, it doesn't matter much for bondholders, says Cheng.

"Once they get this equity financing complete, it is even better for us as a bondholder because we now have a better balance sheet, less debt and better security."

H&R REAL ESTATE INVESTMENT TRUST (HR. un/TSX).

Cheng started buying H&R REIT below \$7 per unit and continues to think it is underappreciated by the market.

As the company continues to build the Bow Tower in Calgary, when it is complete and En-Cana Corp. moves in, the manager thinks investors will be surprised when H&R reinstates almost its full dividend.

The payout was cut in half last year as the REIT needed funds to pay for the project. However, Cheng notes that all of development and conventional financing in place.

"Come late 2011, H&R REIT's distribution (just under 7% now) could jump to 10% to 12%," the manager says, adding that the rest of its Canadian office portfolio is among the best in the country.

SELL

CIBC CAPITAL TRUST bonds (9.976%, June 30, 2019)

The manager has been trimming his position in these Tier 1 notes that were offered by several banks.

After buying them in February basically at par, Cheng doesn't think they present as good value

anymore.

They shot up more than 22% and are now yielding roughly 6.5%.

"You were buying Canadian bank paper at double-digit yields, it was an absolutely brilliant buy," he says.

And while the manager doesn't usually buy Canadian bank bonds, this was a no-brainer.

It's not often that you get to buy a conservative piece of bank debt and get a 25% to 30% return in a matter of months, he adds.