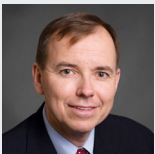




Adventures in global high yield

## ‘Shoulda, woulda, coulda’



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Hindsight, as we know, is a wonderful thing. As T. Rowe Price celebrates its 50<sup>th</sup> anniversary in fixed income investing, I’m pleased to have been along for the ride for 33 of those. If I could go back and do it all over again, what would I do the same? What would I do differently?

When I joined the firm in 1988, my learning curve took off pretty much vertically. The ‘junk bond’ boom was coming off the rails and high yield was going through a period of major upheaval. Two years into my tenure, Drexel Burnham filed for Chapter 11, its founder Michael Milken went to prison, and we saw the worst bear market in the history of the asset class. So, three decades later, what lessons have I taken away?

### **Be a contrarian**

The early years illustrated that, when there’s havoc in the markets, it pays to run toward the fire when others are heading for the exit. The 1998-2002 turbulence was followed by several years of stellar performance. The double-digit spread widening during the Global Financial Crisis resulted in a once-in-a-lifetime rally, and the 2020 Covid-19 shock was also followed by a sharp recovery. Having the ability to pivot from a conservative capital preservation strategy to opportunistic capital appreciation strategy, to be a liquidity provider when everyone else is selling, is an enduring lesson in this market.

### Be a permanent resident

I've also learnt that it pays to be in it for the long haul. There are two kinds of investors in global high yield: permanent residents and tourists. Long-term residents have been rewarded by what Albert Einstein allegedly called the eighth wonder of the world – compound interest. ('He who understands it, earns it. He who doesn't, pays it'.) Early entrants who stayed the course had the benefit of double-digit yields year after year: US\$100 invested in the CSFB High Yield Index in 1988 would have reached \$1,274 by the end of 2020.

### Spot the innovators

Veteran investor Warren Buffett has said that each big industry trend starts with the innovators, followed by the imitators, and finally the incompetents. The goal, of course, is to identify the first and avoid the last.

Backing the early innovators is not always comfortable. I remember getting pushback in the 2010s from clients because two of our holdings – Tesla and Netflix – were burning so much cash flow. Knowing what I know now, there are names I wish we'd bought more of.

One area I wish we'd done more in was in the wireless space. The year before I joined the firm, Gordon Gekko had made Motorola's brick-like DynaTac 8000X look cool in the movie 'Wall Street'. But we didn't realise in the 1990s, when innovators like Western Wireless first came to the US high yield market, just how huge wireless would be as a global growth industry. Western Wireless, via many mergers and consolidations, still lives on in T-Mobile Sprint, which is one of the top three operators in the US today.

With the collapse of the tech, media and telecom (TMT) bubble in 2001, wireless providers came through the crisis better than the wireline businesses, which took years longer to recover. We were overweight wireless, which was a significant contributor to our performance coming out of the crash. Even so, risk-management priorities capped our sector exposure at 10% to 15%. I do sometimes daydream about getting to do my career over as a distressed debt manager.

### Know when to fold

We've had some narrow escapes. When I joined the firm the big US growth sector – one in which we had considerable exposure – was gaming, which had been legalised in the 1970s. Driven by innovators like Steve Wynn, New Jersey's Atlantic City became the luxury casino capital of the world.

But in 1990 a massive new build, the Taj Mahal, came in wildly over budget, issued US\$650 million in 14% first mortgage bonds, made a single coupon payment and then defaulted. The owner, Donald J. Trump, had billed the development as 'the eighth wonder of the world' (although history suggests Einstein was closer to the mark with his compound interest). The Taj, added to the existing Trump Plaza and Trump Castle, disturbed the supply-demand balance in Atlantic City, and contributed to its decline. Wynn, meanwhile, cashed in his chips at the top of the market and went on to Nevada to play his part in the next money spinner: Las Vegas.

### Looking forward

Recent years have brought global high yield spreads to record tightness, and I doubt I'll see another decade of double-digit coupons in my lifetime. That said, I think we could see the outlook improve over the next five years as interest rates 'normalise'. We expect equity returns to moderate over time, with investors' allocations beginning to tilt back to fixed income, and to strategies that are actively managed with higher return potential, like credit, and emerging market debt – sovereign as well as corporate.

Another trend is the growing importance of the private equity world. The high yield market provides a very important source of capital to those companies. I suspect we may see a resurgence in private equity in the next three to five years, and the high yield market is likely to be a fundamental financier of those businesses.

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