

High yield in a broad perspective

NOVEMBER 2019



Kempen

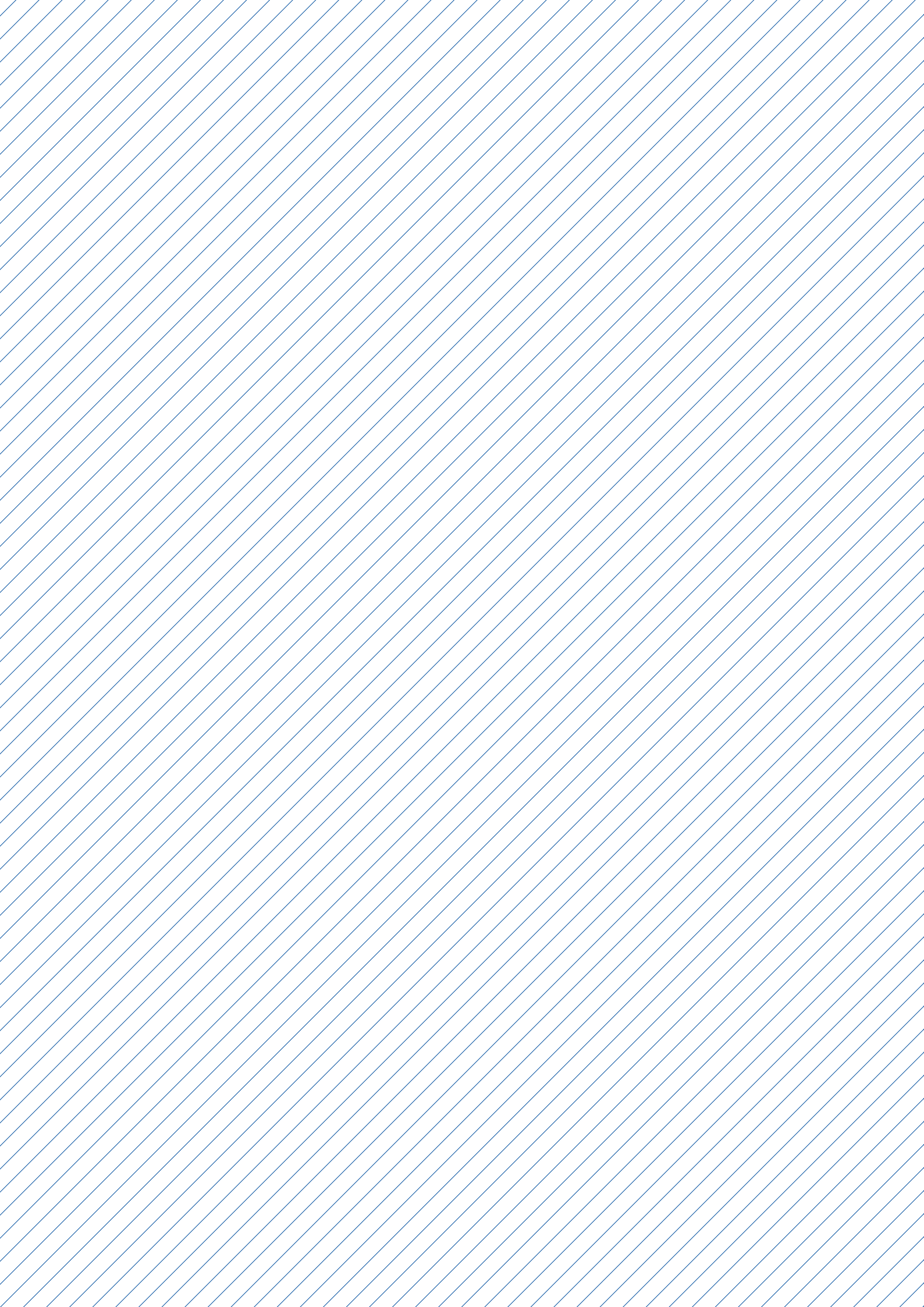


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Introduction

The size of the fixed-income investment markets has grown considerably over the past decade. Existing investment classes have grown significantly, but also new fixed-income asset classes have become available to investors. The accommodative policy of central banks with low interest rates has spurred a search for yield that has led to an increase in capital made available for lending. At the same time, the past few years' robust economic growth has led to a credit demand for growth, investments, mergers, and acquisitions. In emerging economies, particularly fixed-income markets in local currencies have shown significant growth.

This document provides an overview of the most important markets in the high-yield spectrum for the purpose of helping investors choose between these markets for their investment portfolio. In this context, we will limit ourselves to those markets that are sufficiently large and tradable to qualify for investments. The following Chapter will describe the general developments in this part of the financial markets. Subsequently, we will discuss the main asset classes in this market in further detail, shedding light on characteristics such as the composition of the universe, marketability, and sustainability. Fixed-income markets have followed equity markets in embracing sustainability. As a result, these markets offer a wider choice in this area as well, and to an increasing extent. Chapter 8 will describe the expected returns for each asset class as defined by KCM. Chapter 9 will provide an impression of the considerations for including the asset classes in the portfolio.

1. Developments in the high-yield spectrum

The changing role of banks

An important underlying trend is the disintermediation of banks. Ever since the financial crisis, banks around the world have been confronted with mountains of new laws and regulations, making it more expensive for banks to provide credit while at the same time forcing banks to increase their capital buffers. The 'Capital Requirements Directive', for example, requires banks to hold more capital, while one of the requirements of 'IFRS 9' is that at the time of granting a loan, banks already have to provision for potential credit loss as a result of a borrower's failure to pay. This also means that higher-risk lending has become extra expensive for banks and is no longer profitable in many cases. As a result of these and other regulations that were designed to increase the stability of the financial system, disintermediation is, in our opinion, not likely to be a temporary phenomenon.

A good example of the banking sector's withdrawal can be found in the Dutch mortgage market. Traditionally, this market was dominated by the larger banks, but insurance companies and pension funds have managed to gain a substantial market share in recent years. This trend also manifests itself in the market for direct lending to small and medium-sized enterprises, property and infrastructure financing, and financing of 'specialties' such as trade flows, pharmaceutical developments, aviation, and shipping.

Central banks and the search for yield

Since the financial crisis, central banks have pursued unprecedented, ultra-accommodative monetary policies. The central banks of regions including the eurozone, the US, Japan, the United Kingdom, and Switzerland have cut short-term interest rates while at the same time introducing large-scale bond-buying programmes. This depressed long-

term interest rates as well, and strongly decreased the term premium, the additional compensation for making capital available over the longer term.

Investors responded by restructuring fixed-income portfolios. In order to maintain the level of expected returns of the fixed-income portfolio, at least to some extent, investors increasingly invest in fixed-income securities with a lower credit rating, emerging markets, and/or illiquid asset classes.

Although the risks in these asset classes are often higher, an additional advantage is that greater counterparty diversification can be achieved by providing loans to parties including private individuals, SMEs, larger companies, and (semi) public institutions.


The great demand for fixed-income securities and the persistent economic growth in emerging economies have led to strong growth in the universe of emerging market bonds. The gradual opening up of Chinese capital markets provides international investors with access to huge swathes of government and corporate bonds.

The boundaries between the various asset subclasses within the fixed-income segment are fading. The distinction between liquid and illiquid investments is becoming more and more blurred. The financial crisis has shown that the public fixed-income markets do not always offer the desired level of liquidity, and that trade volumes can evaporate quickly. This is yet another playing field where legislation plays a role for intermediaries like (investment) banks due to the decrease in trading volumes. At the same time, a secondary market has arisen for many private, illiquid asset classes that makes it possible to sell investments, whether or not through platforms, under normal circumstances at reasonable conditions.

Sustainability

Sustainability plays an increasingly important role in investors' considerations. Just like in investments in equities, the use of an exclusion policy (to exclude counterparties) has become quite common within fixed-income securities. These exclusions may be based on the UN Global Compact principles, for instance, or they may relate to specific products such as tobacco and (controversial) weapons.

As a holder of a bond (or loan) is not a co-owner, it is more difficult to participate in engagement with a company. On the other hand, companies frequently make an appeal to the bond market on account of (re)financing needs, which opens up a window of opportunity for investors to exert influence. In addition, fixed-income markets offer an opportunity to generate a positive impact on society. In the past few years, for example, we have seen enormous growth in the market for green bonds and social bonds, the proceeds of which are used to generate a positive impact on society or sustainability. Up until today, however, these bonds are predominantly issued by government-related institutions and companies with an investment grade rating.



Besides the bond categories mentioned above, private debt is yet another option in pursuit of a positive impact. Examples include direct, targeted loans to companies that are committed to delivering a positive impact on society and that often have no other access to the capital market. Microfinancing serves as an example in this respect, providing small loans or microloans to private individuals (usually) in emerging economies to start up a small business. Apart from this, impact investments fall outside of the scope of this document.

What will the future bring?

A period of unbridled debt growth is often mentioned as the main cause of the financial crisis. And yet, global debt has already surged to a level that is higher than before the financial crisis. There is a difference, however, as today, these debts are mainly in the hands of so-called 'unlevered' investors. These are investors such as pension funds and insurance companies who operate without using borrowed money, or leveraged finance. The credits are found less often on the banks' balance sheets as they have to comply with more stringent capital requirements.

We expect the growth of debt, and of fixed-income investment markets in their wake, to persist. The difference between the various subclasses of fixed-income securities, bonds, and loans will blur even further. To an increasing extent, investors will want to build well-diversified portfolios, offering space for both liquid and illiquid instruments in both developed and emerging economies. Sustainability will play a crucial role in this process. In this light, we expect a continued interest in the broad spectrum of high-yield asset classes.

2. USD high yield

High-yield bonds are corporate loans with a rating of BB or lower. They are also referred to as 'junk bonds'. The market for high-yield bonds, denominated in US dollars, the US\$ high-yield market, finds its origins in the 1970s and experienced strong growth starting from the mid-1980s. The market for these bonds, therefore, is practically as old as that for the safer investment grade bonds. Initially, companies with a high-yield rating had nothing to resort to but bank loans and the market for private placements. This entailed high financing costs. The only high-yield bonds that were publicly traded belonged to companies that originally had an investment grade rating but whose rating, as a result of deteriorating results, was downgraded to the high-yield category (so-called fallen angels). When the first merchant banks started to issue bonds of companies with a high-yield rating by the end of the 1970s, the market boomed. At intervals caused by several crises, its volume increased from less than US\$ 100 billion in the 1980s to over US\$ 200 billion by the end of the 1990s, after which its growth accelerated to US\$ 700 billion before the financial crisis hit and a volume by the end of 2018 of almost US\$ 1.2 trillion. US\$ bonds represent over 80% of the global high-yield market. This percentage has dropped as the euro high-yield market has likewise grown considerably.

We should note that the number of bonds and issuing companies has slightly decreased over the past decade. The trend of disintermediation that we see in Europe has not hit the American high-yield market. Nearly 70% of American companies turn to the capital market for funding, compared to nearly 30% of European companies. American families also depend on the capital market for almost 75% of their financing needs. The weighted average rating of US\$ high yield as at 31 March 2019 is B+, whereas BBs cover the majority of the universe with 48%, followed by Bs with 40%, and CCC and lower with 12%. The share of CCC and lower is more than double that of the euro high-yield market. In terms of sectors, the energy, media, commodities, and healthcare sectors are relatively large, whereas insurance companies, banks, and the automotive industry are relatively small. In terms of seniority, the US\$ high-yield market contains no hybrid bonds of nonfinancial institutions and a limited number of subordinated bonds.

The American investment grade bond market has grown considerably in the past few years. With ongoing interest-rate reductions and corresponding lower costs of funding, companies have started to use more debt for takeovers and the repurchase of shares. As a result, the average credit rating has declined, and the market volume of bonds with a BBB rating has increased from \$ 900 billion by the end of 2008 to over \$ 3 trillion today. The percentage in the total investment grade market of BBBs over this period of time has gone up from 33% to over 50%. One concern of the market is that when the economy takes a turn for the worse and businesses are pushed into financial distress, many businesses with a BBB rating will be downgraded to BB, moving them into the high-yield universe. One of the risks of such a development would be that given the size of the BBB segment relative to the high-yield market, the market will be unable to absorb this wave of 'fallen angels' without a substantial fall in prices. For the period between 1920 and 2018, Moody's calculates that the average percentage that is down-

CHARACTERISTICS HIGH YIELD USD

Credit risk	3
Interest-rate exposure	2
Liquidity	3
Market size	3
Complexity	1
Costs	1

1 = low, 3 = high

BENEFITS +

long history, widely accepted asset class, liquid

DRAWBACKS -

less seniority than collateralized bonds, concentration to a few sectors, downward risk in times of crisis

graded in a year from BBB to BB or lower is 5.5. This corresponds to \$ 180 billion in debt, which is 15% of the US\$ high-yield market.

Insurance companies and private individuals account for a large share (15-20% each) of the buyers of US\$ high-yield bonds. Investment grade investors with sufficient scope to invest in high yield constitute 5-10% of the market, while the share of hedge funds stands at approximately 5%. The other buyers include pension funds, family offices, foundations, et cetera. Also ETFs play a significant role in the US\$ high-yield market, and a much larger one compared to the euro high-yield market. Experience shows that private individuals (partly through ETFs) and hedge funds can cause selling pressure in line with the trend in bear markets.

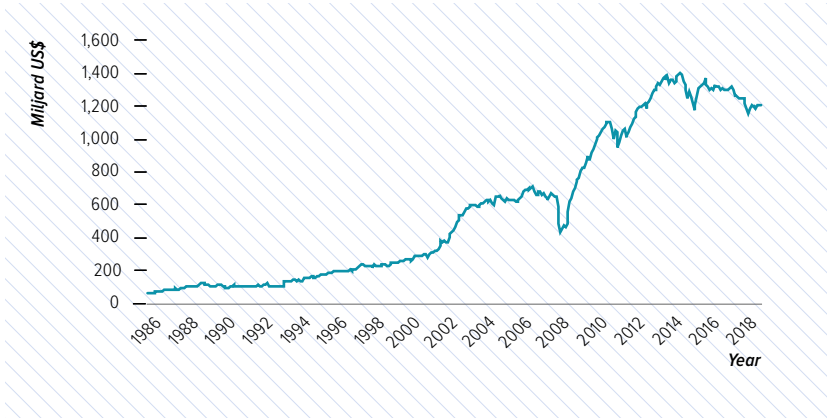
The number of bankruptcies is an important determining factor for the return of high-yield bonds. This number fluctuates strongly and is correlated to the economic cycle. The percentage of bankruptcies in the United States has currently reached an all-time low (2.4% per year) as businesses benefit from the economic recovery as well as from the low interest rates which makes it easier for them to bear their debts. The median of the average annual percentage of bankruptcies of the past 20 years is 3.5%. At the height of the financial crisis in 2008-2009, the percentage of bankruptcies stood at over 14 (source: Moody's, as at 31 March 2019).

An important dynamic is the interaction between the 'leveraged loans' and the high-yield bond market. For companies with a high-yield rating, the most common funding options are issuing a bond on the capital market or taking out a loan with a bank who immediately replaces this loan on the capital market. However, the (bank) loan is secured, whereas bonds are usually unsecured. As a result, the residual value in the event of bankruptcy is lower for bonds than it is for (bank) loans. A study by Moody's for the period between 1987 and 2018 shows that the average eventual residual value for (bank) loans is 80%, compared to 48% for (senior) unsecured bonds. Chapter 5 will discuss loans in further detail.

Compared to other investment classes that offer high returns, liquidity is good in high yield. There is an active market for trading in high-yield bonds. For this reason, most investment funds offer daily liquidity. The average interest-rate exposure is low, with a duration of 3 to 4 years.

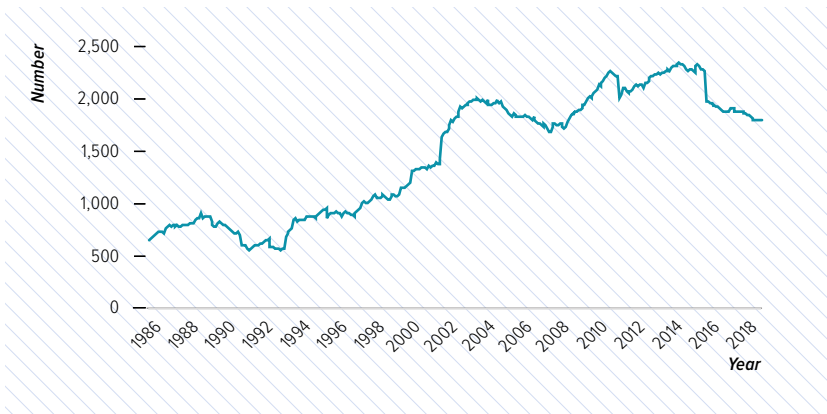
Within this asset class, exclusion is the most common form of ESG implementation. Exclusion of businesses that are involved in the production of controversial weapons and sanctioned enterprises is fairly standard practice, while additional exclusions for violation of the UN Global Compact, tobacco production, and the manufacture of noncontroversial weapons are optional. The investment universe is large enough to exclude these asset classes without impacting risk and return.

MARKET VALUE US\$ HIGH YIELD (\$ BILLION)



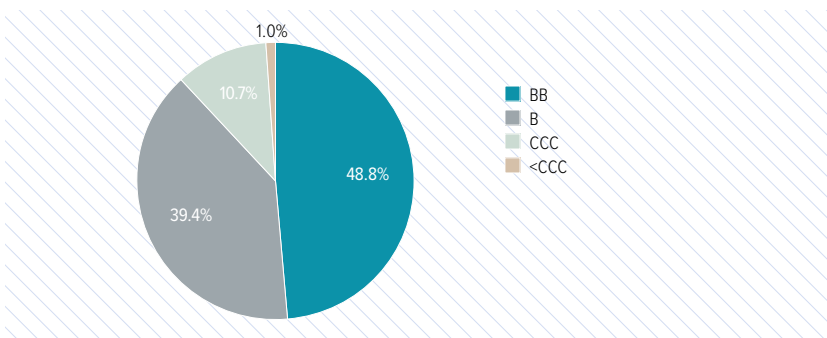
Source: ICE BofAML Indices, Bloomberg Finance L.P., Kempen Capital Management

NUMBER OF US\$ HIGH-YIELD BONDS



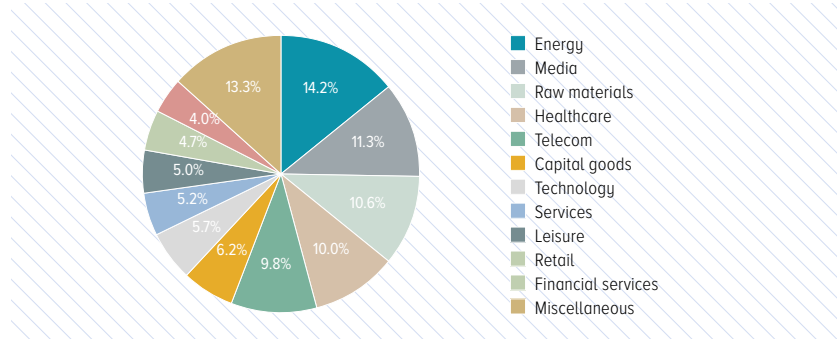
Source: ICE BofAML Indices, Bloomberg Finance L.P., Kempen Capital Management

RATING DISTRIBUTION US\$ HIGH-YIELD MARKET (30 JUNE 2019)



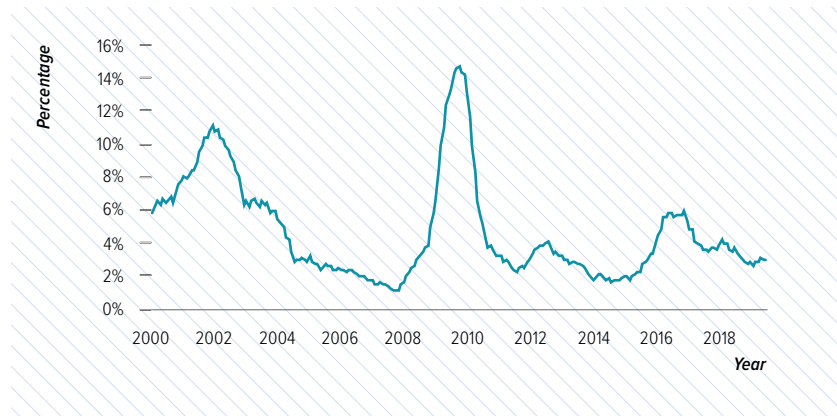
Source: ICE BofAML Indices, Kempen Capital Management

SECTOR DISTRIBUTION US\$ HIGH-YIELD MARKET (30 JUNE 2019)



Source: ICE BofAML Indices, Kempen Capital Management

BANKRUPTCIES US\$ HIGH-YIELD MARKET



Source: Moody's, Kempen Capital Management

3. Euro high yield

Since the financial crisis in 2008-2009, the euro high-yield market has shown strong growth. The size has quadrupled to nearly €300 billion and the number of issuing companies has doubled. This was partly driven by the trend of disintermediation we mentioned before, in which companies want to mitigate their dependence on the traditional banking system and to an increasing extent turn to the capital market to source their funding. Within the eurozone, banks meet three quarters of the funding needs of companies, compared to one third of American companies. We expect the trend to shift from bank funding to capital market funding to continue, resulting in further growth of the euro high-yield market. And if we include the high-yield loans denominated in British pounds, the volume of the market totals over €350 billion.

The composition of the euro high-yield market differs on a number of important aspects from that of the US\$ high-yield market. First of all, the rating distribution is more concentrated in the BB segment, the highest quality within high yield. Over 70% of the market has a BB rating, while this is less than 50% for the US\$ high-yield market. At the lower end of the quality spectrum, we see that the share of businesses with a rating of CCC or lower is only 5% in Europe, whereas this is over 10% for the US\$ market. Besides, the sector distribution is different. The most important difference is the relatively large share of the energy and healthcare sector in the US\$ market, while the manufacturing industry and the banking sector are larger in Europe. Finally, the euro high-yield market has a broader diversification in seniority. In Europe, the high-yield market contains more subordinated loans and hybrid bonds of nonfinancial institutions, whereas this is not the case in the US\$ high-yield market. In summary, the euro high-yield market is of higher quality and more diversified over sectors and seniority.

Traditional investment funds are the largest investors in the euro high-yield market, followed by insurance companies. Also investment grade credit funds represent a significant share of the buyers of high-yield bonds, as most of these funds have the possibility to invest a limited share of their portfolio in high-yield bonds, particularly companies with a BB rating in the so-called 'crossover' segment.

At present, the percentage of bankruptcies is at an all-time low also in Europe due to the robust economic growth and low interest rates. The median of the average annual percentage of bankruptcies in Europe of the past 20 years is 2.5%. At the height of the recession in 2002-2003 and the financial crisis in 2008-2009, the percentage of bankruptcies stood at over 12 (source: Moody's).

Also in Europe, the liquidity is good compared to other investment classes that offer high returns. There is an active market for trading in high-yield bonds. For this reason, most investment funds offer daily liquidity. The average interest-rate exposure is low, with a duration of 3 to 4 years. Within this asset class, exclusion is the most common form of ESG implementation, just like in US\$ high-yield bonds.

CHARACTERISTICS

HIGH YIELD EURO

Credit risk	2
Interest-rate exposure	2
Liquidity	3
Market size	2
Complexity	1
Costs	1

1 = low, 3 = high

BENEFITS



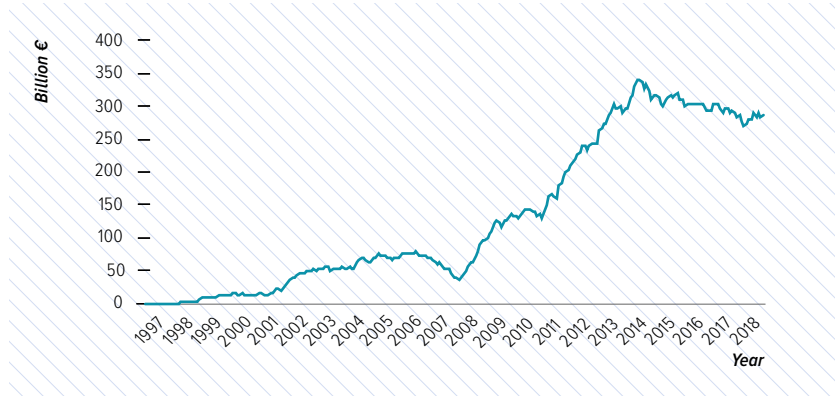
Growing market benefiting from disintermediation, relatively high rating, liquid

DRAWBACKS



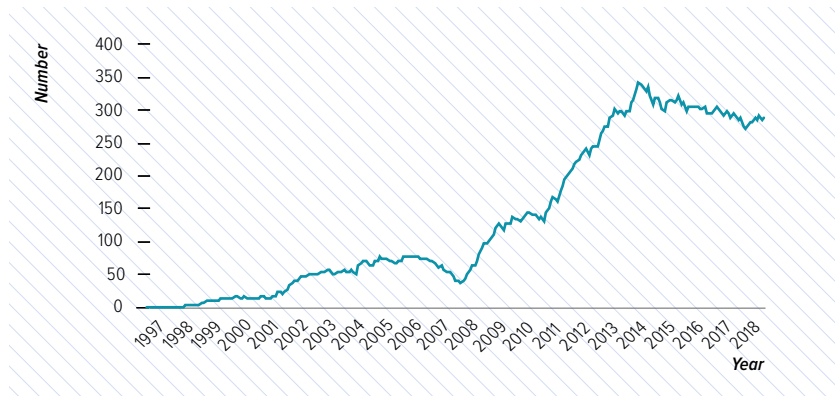
relatively limited in size, higher share of subordinated bonds

MARKET VALUE EURO HIGH YIELD (€ BILLION)



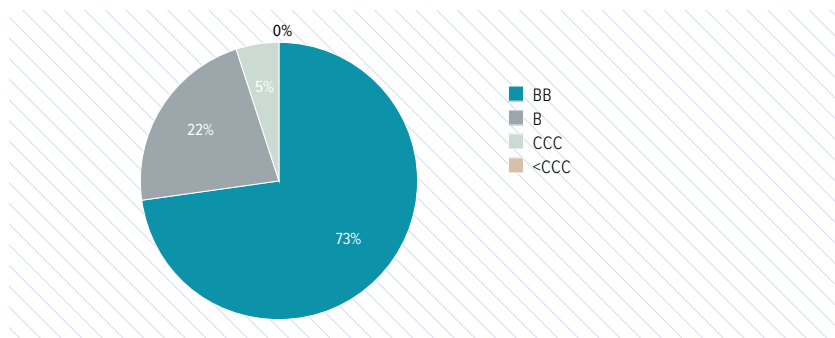
Source: ICE BofAML Indices, Bloomberg Finance L.P., Kempen Capital Management

NUMBER OF EURO HIGH-YIELD BONDS



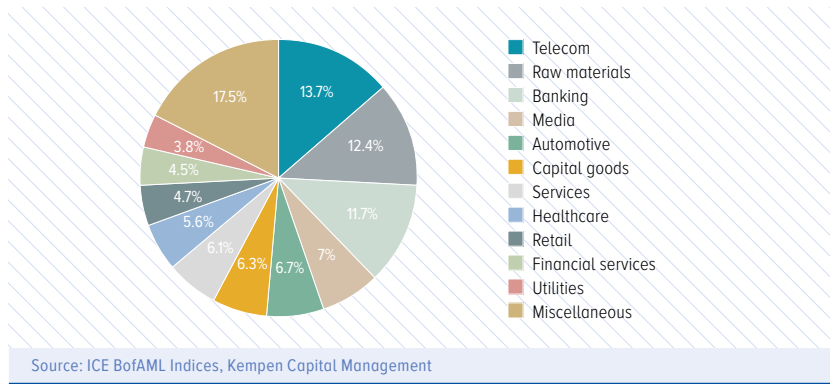
Source: ICE BofAML Indices, Bloomberg Finance L.P., Kempen Capital Management

RATING DISTRIBUTION EURO HIGH-YIELD MARKET (30 JUNE 2019)



Source: ICE BofAML Indices, Kempen Capital Management

SECTOR DISTRIBUTION EURO HIGH-YIELD MARKET (30 JUNE 2019)



BANKRUPTCIES EURO HIGH-YIELD MARKET



4. Emerging market debt

Emerging Market Debt (EMD) is a term that is used to categorize debt securities issued by less well-developed countries and companies. Fundamental differences between emerging countries may be great, varying from net importers of raw materials to net exporters, and varying from large current account deficits to surpluses.

In the 1970s, there was no market for EMD, with mainly multinational banks in the United States and Europe being active lenders to emerging countries, particularly to Latin America. EMD as a trading market began shortly after the Latin American debt crisis in 1982, when Mexico was unable to service its debt. Other countries soon followed. A key development for EMD was the Brady Plan of 1989-1990, which allowed countries to restructure their debt. Subjected to a 'haircut' (i.e., lower interest rate or face value), loans were converted into more tradable instruments (Brady bonds) with the principal amount usually collateralized by US government bonds. This let commercial banks reduce the debt on their balance sheet and allowed sovereign risk to be diversified over other investors, away from banks. Early in the 1990s, the first EMD benchmarks were introduced.

An important distinction within EMD is the difference between 'local' and 'hard' currency. In local EMD, the bonds are denominated in the local currency of emerging countries, while in hard currency, the bonds are usually issued in US dollar. This leads to a difference between the risk characteristics of both subclasses. Hard currency bonds are issued in nonlocal currencies. This means that a drop in local currency (or a rise in USD) will make it more expensive for the issuing country to pay coupons and repay the bonds. Printing more of the country's own currency is not an option in this case, as this will presumably lead to a further decline of the local currency. To mitigate risks, these countries will, therefore, have to stock up on sufficient of the hard currency in which the bonds were issued to be able to meet their obligations. For EMD in local currency, the credit risk is lower. The exchange rate risk, however, is higher, in view of the exposure to a local currency. If this currency drops in price, the value of the investment will drop along with it, even in the event that the creditworthiness stays the same.

Initially, the market for EMD was predominantly a USD-denominated market as international investors were reluctant to take on emerging market currency risk. However, as fundamentals and credit ratings improved, more and more countries were able to issue local currency denominated debt. Today, the market for local currency denominated sovereign EMD is much bigger than for hard currency denominated sovereign EMD. We estimate the market for hard currency denominated sovereign bonds at approximately USD 975 billion, compared to a USD equivalent of 8,350 billion for local currency denominated sovereign bonds. The investable market of local currency denominated sovereign bonds is smaller than this amount, but growing fast. Below we will list and

describe a few of the main characteristics of the most commonly used local and hard currency benchmarks as at the end of March 2019. Please note that for diversification purposes, the maximum weight of each country in these benchmarks is capped (at 10%).

Bankruptcies can have a significant impact on the return of EMD. Compared to developed countries, bankruptcies occur relatively frequent in emerging countries. According to Moody's definition, the biggest sovereign defaults of the past decade are Greece (2012), Argentina (2014), Ukraine (2015), and Venezuela (2017). Credit rating agencies have noted that the quantity of debt in emerging countries keeps rising, where particularly those countries with limited fiscal flexibility or significant (short-term) debts denominated in foreign currency are vulnerable.

Liquidity of EMD sovereign bonds is similar to liquidity in investment grade corporate bonds. The liquidity is, therefore, lower than for sovereign bonds of developed countries. A survey conducted by Barclays (2018) shows that the fees for trading in hard currency EMD are slightly higher than those for local currency EMD.

ESG is a pre-eminently relevant subject within this asset class. In emerging countries, subjects such as corruption, human rights, and how to deal with the environment and the climate are usually less well-regulated than in developed countries. Particularly the hard currency universe includes countries that are vulnerable in the area of ESG (e.g., Lebanon, Nigeria, Venezuela, Iraq, et cetera). In addition, the universe includes, to a limited extent, government-guaranteed companies, such as PetroChina, which has violated the UN Global Compact.

Asset managers should at the very minimum comply with the sanctions legislation. Additional exclusion is an option, although in the local currency universe, this could lead to a material tracking error. Furthermore, there is a correlation between creditworthiness and ESG, as poor management has an impact on both. The resulting portfolio with exclusions will be of a more defensive nature (lower yield and lower volatility). For implementation purposes, the ESG variety of the most commonly used J.P. Morgan index can be followed. Based on ESG factors, this index gives a higher weighting to countries that perform well and vice versa. In addition, green bonds are given a higher weighting and companies are screened for their involvement in the production of coal, tobacco, weapons, and violation of the UN Global Compact.

Local currency

As at the end of March 2019, the J.P. Morgan GBI-EM Global Diversified index consisted of 217 bonds issued by 19 countries. 77% of the index has an investment grade rating, and 23% are high yield with an average rating of BBB. The average maturity is 7.6 years, and the average duration is 5.2 years. The regional distribution is 35% for Latin America, 28% for Eastern Europe, 25% for Asia, and 12% for the Middle East and Africa. The biggest debtors in the benchmark, those with the maximum weight of 10%, are Brazil, Mexico, and Indonesia. Also Poland, Thailand, and South Africa are weighted heavily in the index.

CHARACTERISTICS

EMD LOCAL

Credit risk	1
Interest-rate exposure	3
Liquidity	3
Market size	3
Complexity	1
Costs	1

1 = low, 3 = high

BENEFITS



relatively large in size, liquid, risk diversification

DRAWBACKS

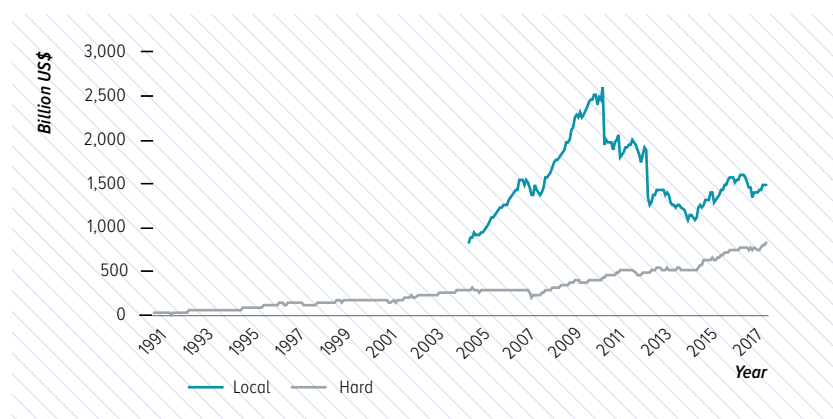


foreign exchange risk, concentration to debtors, volatility

Hard currency

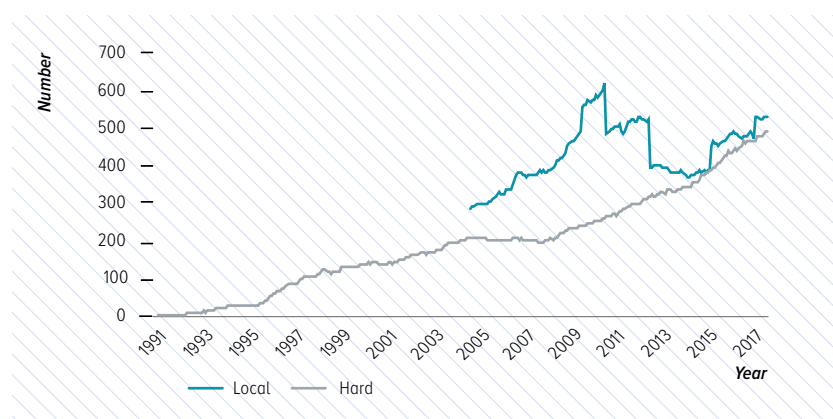
As at the end of March 2019, the J.P. Morgan EMBI Global Diversified index consisted of 746 bonds issued by 73 countries. 49% of the index has an investment grade rating, and 51% are high yield with an average rating of BB+ (so lower than the local currency index). The average maturity is 11.2 years, and the average duration is 7.0 years. The regional distribution is 36% for Latin America, 19% for Eastern Europe, 19% for Asia, and 26% for the Middle East and Africa. Compared to the local currency index, this benchmark, therefore, has a significantly higher weight in the latter region. The biggest debtors in the benchmark are Mexico (4.7%), Indonesia (4.3%), and China (4.2%), followed at a distance by Turkey (3.3%), Russia (3.2%), and the Philippines (3.2%).

MARKET VALUE LOCAL AND HARD CURRENCY EMD (\$ BILLION)



Source: Thomson Reuters Datastream, Kempen Capital Management

NUMBER OF LOCAL AND HARD CURRENCY EMD BONDS



Source: ICE BofAML Indices, Kempen Capital Management

CHARACTERISTICS

EMD HARD

Credit risk	2
Interest-rate exposure	3
Liquidity	3
Market size	2
Complexity	1
Costs	1

1 = low, 3 = high

BENEFITS



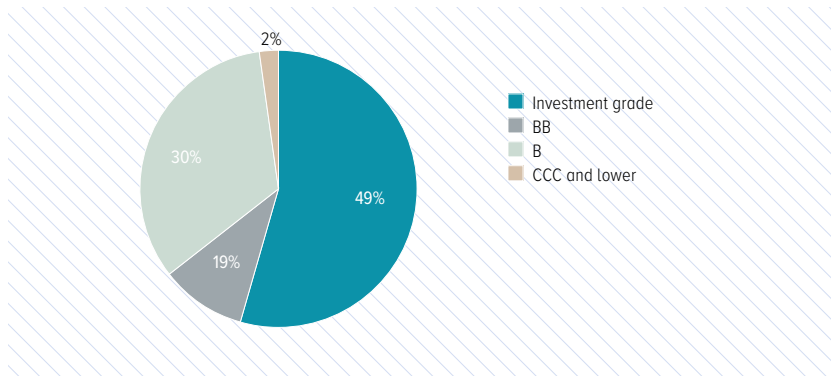
only USD currency risk, liquid, debtor diversification

DRAWBACKS



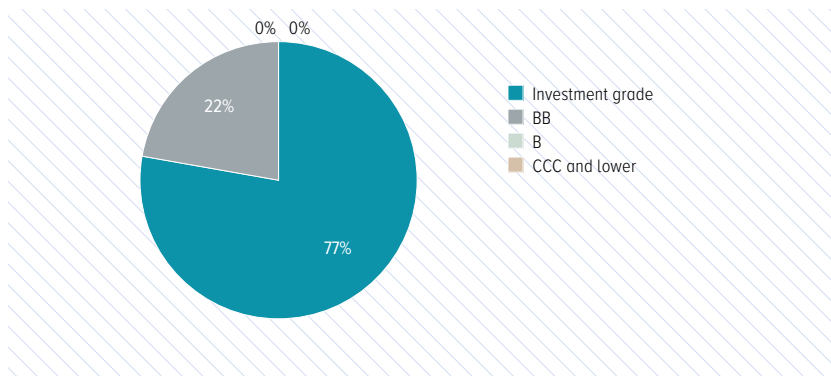
concentration to region, limited growth in this segment

RATING DISTRIBUTION HARD CURRENCY EMD (31 MARCH 2019)



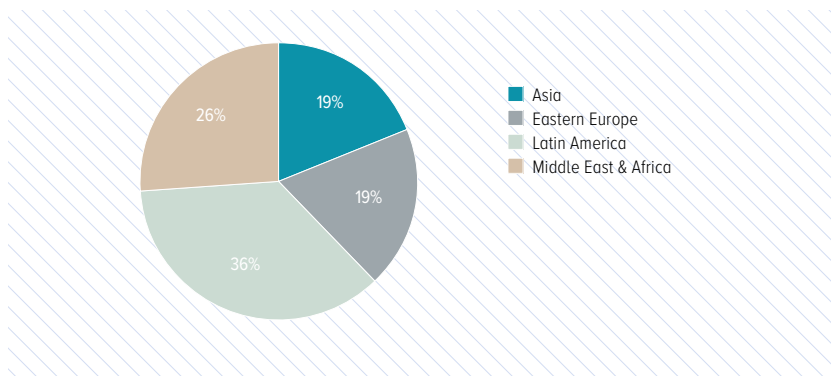
Source: J.P. Morgan, Kempen Capital Management; as at 31 March 2019

RATING DISTRIBUTION LOCAL CURRENCY EMD (31 MARCH 2019)



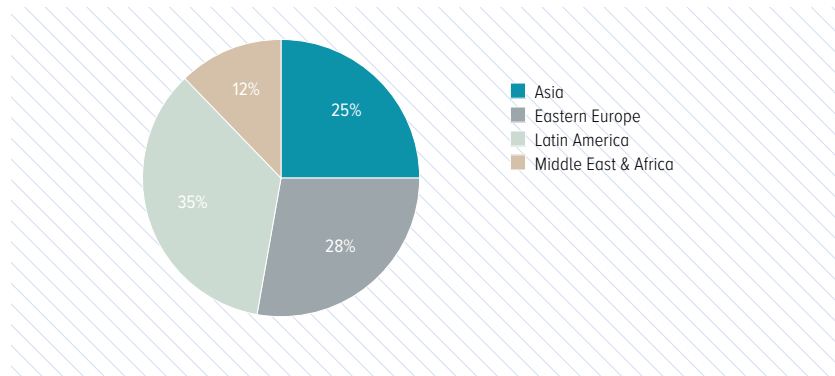
Source: J.P. Morgan, Kempen Capital Management; as at 31 March 2019

REGIONAL DISTRIBUTION HARD CURRENCY EMD



Source: J.P. Morgan, Kempen Capital Management; as at 31 March 2019

REGIONAL DISTRIBUTION LOCAL CURRENCY EMD



Source: J.P. Morgan, Kempen Capital Management; as at 31 March 2019

	HARD	LOCAL
Index	JPM EMBI Global Diversified	JPM GBI-EM Global Diversified
Currency	Hard	Local
# bonds	746	217
# countries	73	19
% investment grade	49%	77%
% high yield	51%	23%
Average rating	BB+	BBB
Average maturity	11.3 years	7.6 years
Average duration	7.0 years	5.2 years

REGIONAL DISTRIBUTION

Latin America	36%	35%
Eastern Europe	19%	28%
Asia	19%	25%
Middle East	26%	12%

BIGGEST DEBTORS

Mexico (4.7%)	Brazil (10%)
Indonesia (4.3%)	Mexico (10%)
China (4.2 %)	Indonesia (10%)
Turkey (3.3%)	Poland (9%)
Russia (3.2%)	Thailand (8.5%)
Philippines (3.2%)	South Africa (8.5%)

5. Leveraged loans

A loan is a contract between a lender and a borrower (a company), the terms of which are decided by agreement. What makes the loan 'leveraged' is the high-risk character of the borrower, who often has a considerable amount of debt and a limited cash flow. The leveraged loan market offers the opportunity to trade these loans, and it was not until this century that it really started to develop. Before that, these loans were parked on the balance sheets of banks and other financial institutions. Later on, an active market developed, in which banks can sell these loans to other investors.

The size of the total liquid leveraged loan market is estimated at approximately USD 1,200 billion. The share of European loans in this figure amounts to approximately USD 200 billion. According to the central bank of England, the overall market is worth USD 2,200 billion if we include also the issues of smaller, less liquid loans and loans held by banks. The leveraged loan market has grown considerably in recent years, and it has more than doubled since 2012. This can be attributed to the increasing demand among investors for alternative ways to achieve returns in the current environment of low interest rates, and the willingness among companies to issue more debt via the capital market. The leveraged loan market even grows faster than high yield, as borrowers have to comply with fewer covenants (please refer to the section below), there is greater flexibility to repay the loan whenever convenient, and loans are cheaper than bonds.

Leveraged loans have a lot in common with high-yield bonds. The ratings of the underlying companies are high yield (B on average), the loans are not traded on the stock exchange but over the counter instead, and the market size is similar. And yet, there are differences. A loan is backed by collateral. Leveraged loans can be secured by property, for instance. This gives them higher priority in the hierarchy of creditors in case of insolvency, resulting in higher residual values. In addition, the interest rate on a loan is linked to the current market interest rate. The interest rate is usually set to 3-month Libor or Euribor plus a credit risk spread. Due to their floating-rate character, the interest-rate exposure of loans is limited, in contrast with bonds, which have a fixed interest rate. This also makes leveraged loans interesting compared to high yield for investors who expect interest rates to rise. In addition, the documentation of traditional loans contains covenants (terms and conditions) that companies have to continue to adhere to throughout the life of the loan. This allows lenders to monitor the results of the company and to force it to take action whenever necessary. Examples include the condition that the quantity of debt relative to the share capital, assets and/or profitability should not exceed a certain threshold limit and that the profitability should sufficiently cover the mandatory interest charges.

An important trend that we have seen in recent years is the increasing issuance of so-called 'covenant-lite' loans. In contrast to the first few years after the financial crisis, an increasing percentage of the documentation of newly issued leveraged loans contains no or only a limited number of covenants designed to protect the interests of investors. In fact, according to credit rating agency Standard & Poor's, 85% of the

CHARACTERISTICS

LEVERAGED LOAN EURO

Credit risk	2
Interest-rate exposure	1
Liquidity	2
Market size	2
Complexity	2
Costs	2

1 = low, 3 = high

BENEFITS



secured loans, low
interest-rate exposure

DRAWBACKS



downward covenant trend,
limited liquidity

global leveraged loans issued in 2018 were 'covenant-lite' loans, which is a record high. In 2007, this was only 25%. The increase in 'covenant-lite' loans has raised concerns among global authorities such as the central bank of England and the IMF, and some are calling for stricter regulation. In 2013, American regulatory authorities already issued a guideline recommending against banks under supervision making loans to companies with a leverage (debt to operating profit) ratio greater than six times.

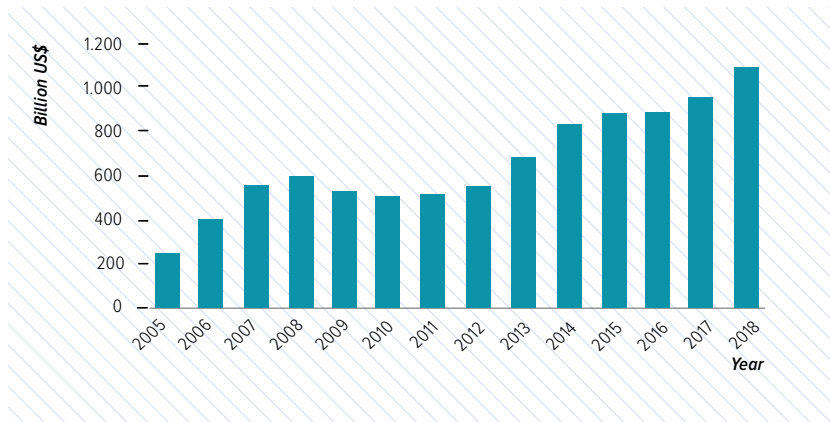
A large share (45%) of the leveraged loans is packaged into so-called collateralized loan obligations (CLOs), structured vehicles that pool loans and split them up into tranches with different risk profiles, which are subsequently resold to investors. Nearly one third of the leveraged loans is sold to funds and insurance companies. In recent years in the US, retail investors have found their way to the asset class, now representing almost 20% of the market. Private individuals invest mainly through trackers, leading to a substantial increase in the share of ETFs in the market.

Just like for high-yield bonds, the number of defaults is an important determining factor for the return of leveraged loans. Also in this asset class, the number of defaults is low at this point in the cycle, ~1%, compared to a historical average of over 3%. At the height of the crisis, this stood at over 10%. As mentioned in the paragraphs on high yield, the residual value of leveraged loans is higher than for high yield given the collateral security provided.

Liquidity is significantly lower compared to high-yield bonds. According to figures published by the Loan Syndication and Trading Association, the traded volume of leveraged loans is approximately USD 50 billion a month, whereas this volume is reached in as little as 1.5 days in the high-yield market. The high-yield market is, therefore, nearly fifteen times more liquid. Besides the fact that loans are less liquid than bonds, the settlement also takes up more time. On average, these transactions are settled eleven days after the day of trade, compared to two days for bonds. This lower liquidity and slow settlement times can lead to problems for investors who have invested through instruments that offer daily liquidity (such as ETFs). In the case of large transfers from these instruments, there is a considerable risk that the underlying loans cannot be sold in similar quantities and at a similar speed. This can result in large (downward) price movements, and may even prompt suppliers of these instruments to obstruct such withdrawals. A development of this kind was briefly seen in the US in December of 2018.

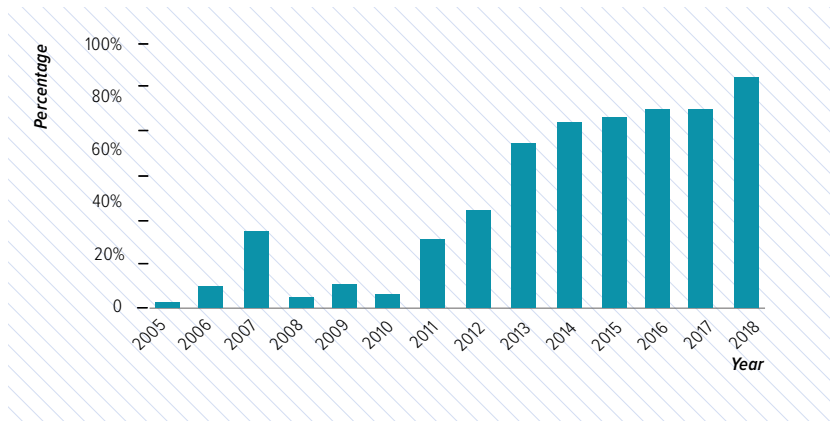
Within this asset class, exclusion is the most common form of ESG implementation. Only to a highly limited extent, companies in this universe are involved in the production of controversial weapons, tobacco or noncontroversial weapons. The companies usually do not have an assessment on the UN Global Compact, so exclusion will hardly affect their risk and return.

SIZE OF THE AMERICAN LEVERAGED LOAN MARKET (\$ BILLION)



Source: Bloomberg Finance L.P., S&P/LSTA Leveraged Loan Index

PERCENTAGE OF 'COVENANT-LITE' OF THE TOTAL ISSUANCE OF LEVERAGED LOANS



Source: S&P Global Market Intelligence, Kempen Capital Management

BANKRUPTCIES OF GLOBAL ISSUERS OF LEVERAGED LOANS



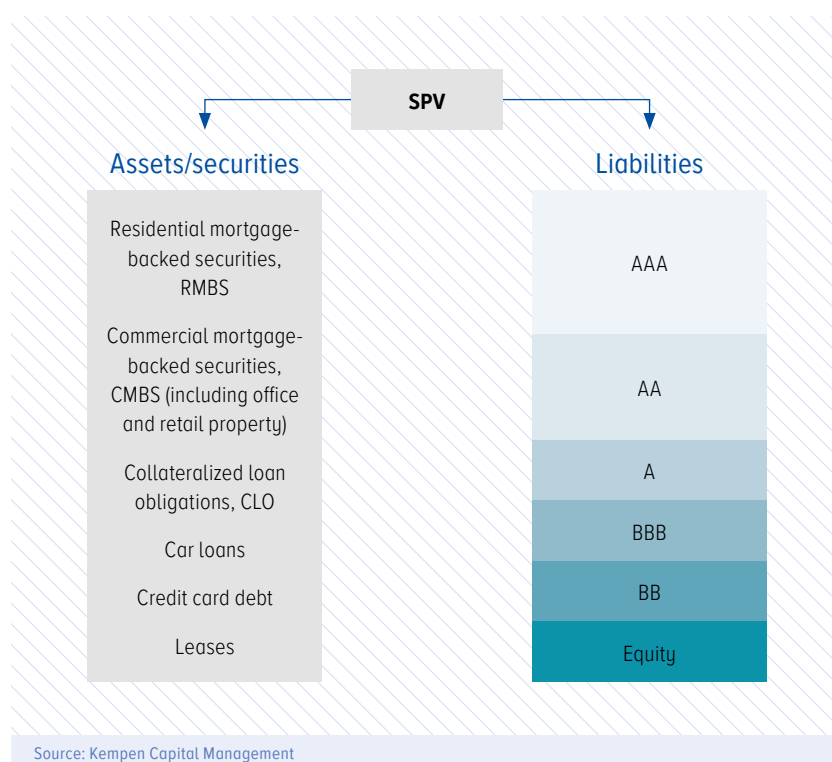
Source: Moody's, Kempen Capital Management

6. Structured credit

Structured credit is an umbrella term for structured products in which a collection of underlying credit instruments is packaged into a separate entity (a special purpose vehicle, or SPV). By means of securitization, the entity is subsequently divided into tranches with different credit qualities that are sold to investors. Usually, this involves residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), and consumer asset-backed securities (consumer ABS). Below is an illustration of a typical structure.

CHARACTERISTICS	
STRUCTURED CREDIT USD	
Credit risk	2
Interest-rate exposure	1
Liquidity	2
Market size	3
Complexity	3
Costs	2

1 = low, 3 = high



BENEFITS



large size, layered structure offers buffer against losses, consumer risk exposure

DRAWBACKS



complexity, leverage in the structure, volatility in bear markets

According to SIFMA, the total size of the structured credit market amounted to approximately USD 4,500 billion by the end of 2018, a third of which is backed by European collateral while two thirds are backed by American collateral. By way of comparison, this is bigger than the high-yield and leverage loan markets put together, and even bigger than the market for European investment grade corporate bonds. Split up into types of collateral, the market can be divided into 35% RMBS, 13% CMBS, 16% CLOs, 32% consumer ABS, and 4% miscellaneous. We should note, however, that the European market concerns predominantly RMBS and consumer ABS, whereas in America, the volume of consumer ABS and CMBS is relatively larger. Structured credit offers the opportunity to invest in consumer credit risk, which, as a rule, is not possible in other high-yield bonds.

The tranches of a structured product vary in risk, have a corresponding rating, and derive their value from their underlying security. The higher the tranche is in the structure, the safer it is, but also the lower the interest rate. The cash flows from the collateral are used to pay the interest and redeem the principal for the various tranches, while the available funds are divided through a 'waterfall', paying AAA tranche holders first, then AA, et cetera. Whatever is left is spilled down the cascade. This means that if the collateral fails to yield sufficient cash flows to pay all the tranches, due to default or other causes, the bottom tranches are not paid (or not all that is due). In exchange for this risk, the interest received rises as investors invest lower in the structure. Repayments (in full or in part) of loans that back the tranches are usually likewise used to repay the principal of the tranches, again starting with AAA and moving on to AA, et cetera. Each tranche in the structure, therefore, has a buffer against possible losses in the form of tranches that are lower in the structure. In addition, there is often an additional buffer against losses in the form of excess value of the collateral (the value of the assets is greater than the value of the liabilities) and a higher interest rate on the assets than on the bonds. Like leveraged loans, structured credit bonds have a variable interest rate linked to Libor or Euribor plus a spread, limiting the interest-rate sensitivity and making these instruments a good alternative for investors who expect interest rates to rise.

The effective yield (credit spread) on tranches of a structured product is usually 1 to 3% higher than that for a corporate bond with a similar credit rating. This can be attributed to several causes. A structured credit bond adds an extra layer of complexity as not only an understanding of the underlying loans, but also the nuances of the structure are important. In addition, tranching structured credit bonds leads to leverage in the structure (because of tranche thickness and place in the structure). Furthermore, the market for these bonds is shallower; fewer investors look into these instruments compared to corporate bonds, for example. In the past, these bonds proved less liquid as a result, leading to strong price fluctuations. On the other hand, the extra credit spread as a result of complexity offers opportunities to specialists.

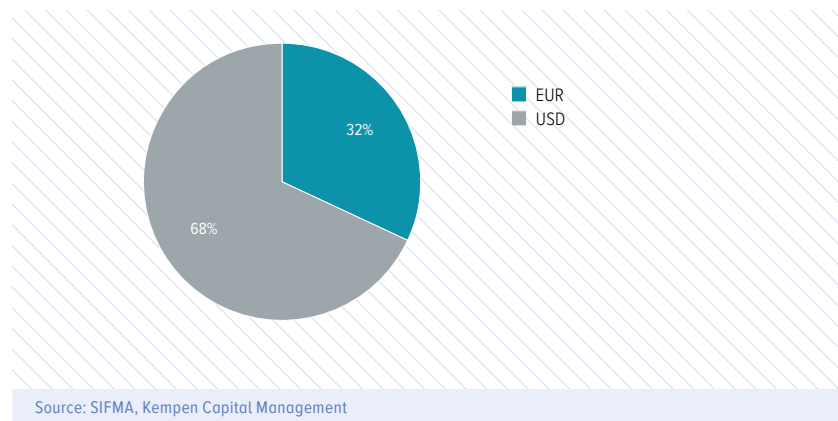
As many American subprime mortgages, or junk mortgages, were packaged before the financial crisis hit, many investors in these tranches suffered losses, not just because of the – in hindsight – poor state of the collateral backing the loans, but also because the tranches in the structure were thinner at the time and positioned lower in the structure, making them riskier. As a result, the image of structured credit suffered a major blow. Many investors at the time turned their backs on this market for good. However, for the vast majority of structures backed by different types of security, investor losses were limited, totalling much less in Europe than in the US. Moreover, after the crisis, the structures became safer, and today, the market attracts a different type of investors. Driven by aspects including strict regulation, rules for the composition of collateral have been tightened, and higher capital requirements apply to tranches in the structure. The latter means that today, a larger buffer has to be set aside in the form of a lump sum in cash and other tranches in order to receive a similar rating for a tranche relative to the time prior to the crisis.

An 'AA' tranche issued after 2008, therefore, is better protected against losses than an 'AA' tranche issued before 2008.

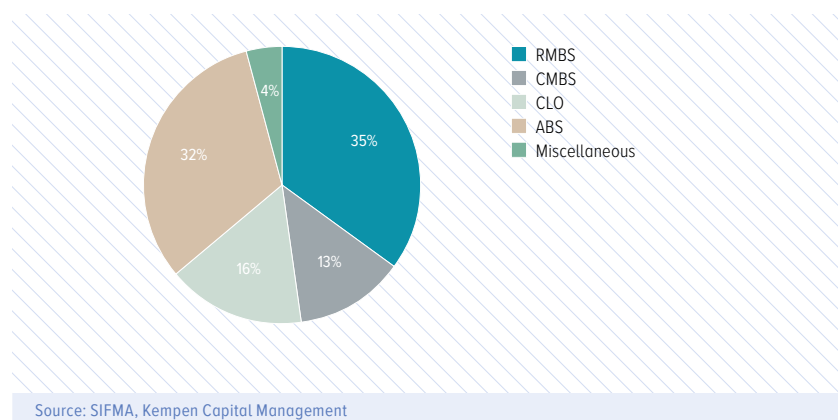
As every structure with its corresponding underlying assets is unique, investing in structured credit requires an intensive process and relevant specialized knowledge. As a result, the common method of investing in this asset class is through managers, especially in the United States, or via fund-of-funds structures.

Within this asset class, implementation of ESG by means of exclusion and engagement is less relevant. The underlying loans are provided in regulated markets, with asset managers assessing whether or not funding is excessive or rates are too high. This assessment is integrated into the investment process of the asset manager.

STRUCTURED CREDIT MARKET SPLIT UP INTO CURRENCIES



STRUCTURED CREDIT MARKET SPLIT UP INTO TYPES OF PRODUCT



7. Direct lending

Companies have three options to raise funding: (i) through banks, (ii) through the capital market ('public debt') or (iii) through private loans ('private debt'). Direct lending is a form of private debt. Direct lending is a term that is used broadly for private, unlisted loans provided to corporates without involvement of the banking industry or the capital market.

The credit crunch of 2008 was an important turning point for direct lending. The ensuing unrest accelerated the rise of this new institutional investment class, partly as a result of a number of developments. First of all, banks were restricted in extending credit to medium-sized companies as a result of higher capital requirements. Secondly, companies felt a need to fund recovery after the crisis and further growth, and to refinance outstanding loans. Banks were unable to meet this increasing demand, thus opening up a window of opportunity that alternative lenders such as direct lending investment funds were eager to grasp. In our opinion, this trend of disintermediation, in which more and more lending is conducted outside of the banking system, will persist. An additional driver of this trend is the search for yield as a result of the persistently low interest rates and the large quantity of available liquidity due to the quantitative easing programme of the European Central Bank. Investors are looking further than traditional liquid fixed-income securities and are willing, through investment funds, to provide credit to medium-sized companies in exchange for higher yield and additional diversification.

Although direct lending has a long history in the United States, this is not the case in Europe. The European direct lending market is growing at a steady pace, but its size is still fairly small. Preqin estimates that the quantity of capital available for direct lending amounted to EUR 108 billion by the end of 2018, with an estimated ratio of 60% for Europe to 40% for the United States. The European market is an upcoming market that is less mature and less efficient. The heterogeneity of the market should enable a specialized market player to add value. From a historical perspective, the credit spread per unit of financial leverage, so the risk compensation, has been higher in Europe than in the US. Moreover, recovery values in case of default have been higher. For these reasons, we prefer European direct lending over American direct lending, and we will continue to focus on the European market.

Private equity parties are an important involved party when it comes to direct lending. When they take over medium-sized enterprises, they often need funding to do so. If they own a business, they will in many cases have set ambitious growth targets for these companies, which in turn will lead to financing applications. Even though no exact data are available, we estimate that more than half and up to three quarters of the European direct lending middle-segment loans have been provided to companies with a private equity owner. An advantage is that private equity parties themselves contribute significant shareholders' equity to the company, and go to great lengths to prevent this from evaporating. In addition, they usually conduct in-depth research before providing capital, and they are subject to strict monitoring. A disadvantage is

CHARACTERISTICS

DIRECT LENDING EURO

Credit risk	2
Interest-rate exposure	1
Liquidity	1
Market size	1
Complexity	2
Costs	3

1 = low, 3 = high

BENEFITS



growing segment, exposure to SME, seniority in the capital structure

DRAWBACKS



illiquid, limited history, limited choice due to limited number of funds

that private equity parties sometimes impose fairly aggressive growth targets and funding structures on their companies, which may jeopardize the stability of the company. It is the task of direct lending funds to remain disciplined and to refrain from lending money unless the risk-return ratio is attractive.

The interest rate on loans is based on the variable short-term risk-free interest, often with a minimal floor of 0.5% or 1%, plus a considerable spread of between 4.5% and 10%. Accordingly, the interest-rate sensitivity is low, just like with leveraged loans and structured credit. The average maturity of a loan is 4 to 6 years, and the loans are nontransferable (illiquid). The loans sit high up in the capital structure, with seniority over other lenders including subordinated debt and share capital. Just like with leveraged loans, the documentation of these loans contains covenants that companies have to continue to abide by throughout the life of the loan, and that help to maintain control over the companies and to exert influence in times when the companies run into problems. The loans are provided to medium-sized European companies with a going concern value of up to approximately EUR 500 million and/or operating earnings of between about EUR 10 and EUR 75 million. Here, we see an important difference with leveraged loans, where the loans (and the businesses) are bigger. Medium-sized enterprises are usually too small to have a rating from credit rating agencies, and partly due to their limited size, they are predominantly categorized as high yield. The debt to operating profit ratio usually varies between four and five times. This emphasizes the importance of forming a sound opinion on their credit profile.

As the market for direct lending is relatively young in Europe, only limited historical data are available. Particularly data on realized returns, defaults, and residual values are available only to a limited extent. Many direct lending funds started up around 2012-2013, and only a handful of fund managers have a track record that dates back to 2009-2010. In view of the fund structure, the return of direct lending, like with private equity, is measured in Internal Rate of Return (IRR) on invested equity. In the IRR method, timing and the amount of cash flows strongly impact the return, whereas in regular asset classes, where the invested equity is much more stable, this is not frequently the case.

Up to now, returns of European direct lending funds have been good, with IRRs of 9% up to 11% per year. A few observations are in order in this respect. Firstly, we have not yet been through a full credit cycle, and the market conditions have been nothing but relatively favourable so far. Besides, the final phase of most direct lending funds has not yet been fully concluded, and the balance sheet cannot be prepared until the loans have been successfully repaid. In the United States, the direct lending category has existed for quite a while longer, with average annual IRRs starting from 1999 until 2011 varying between 3% and 15%. For representative percentages on bankruptcies and residual values, we can use numbers that are similar to the leveraged loan market.

Liquidity is very low. Direct lending funds have no liquidity for between six to eight years. The fund term is usually six years, with the option of renewal for an additional two years maximum. In this respect, the funds are consistent with the average maturity of the underlying loans. The loans are normally held to maturity and until that time, there is no or very little liquidity. Usually, direct lending funds contain a limited number of investments (25 to 40 loans) and may be concentrated to loans to companies within the same industry, while some sectors are excluded altogether. As a result, the performance of a number of investments or a certain industry may affect the aggregate fund returns.

Given the aforementioned market characteristics, selecting the right fund manager is of the essence. We estimate the number of European direct lending managers at around 40. Only about ten of them have a substantially sized team with a long-term track record.

Within this category, exclusion is the most common form of ESG implementation. Only a very limited number of companies in this universe are involved in the production of controversial weapons, tobacco, and noncontroversial weapons. The companies usually do not have an assessment on the UN Global Compact, so exclusion will have only a limited impact on risk and return.

As direct lending funds are usually illiquid and the investments are not yet known at the start, careful assessment of the integration of ESG into the investment process of the manager deserves preference. In addition, several managers have signed the PRI and report on this aspect.

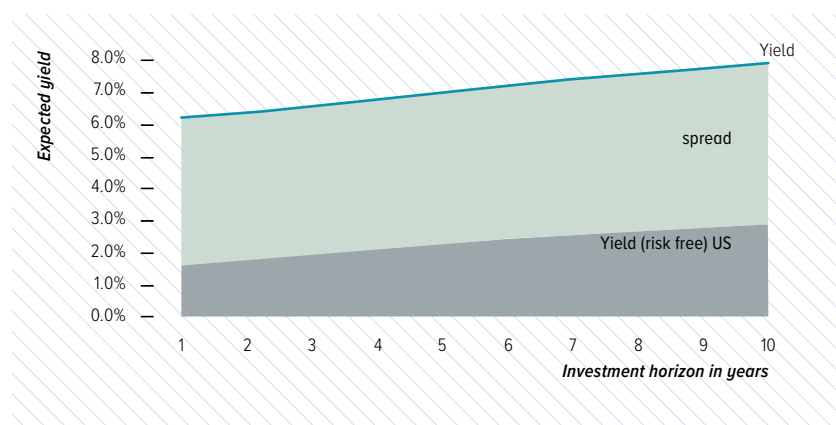
8. Return expectations

Our expected returns are the result of our long-term (10-year) vision for markets and asset classes. For this long-term vision, we use scenario analysis on an extensive scale. We annually prepare a number of scenarios based on our vision on various economic and social trends. The most likely scenario in our view is referred to as the central scenario. As uncertainty is inherent to predictions about the future, we prepare a number of alternative scenarios besides our central scenario. In these alternative scenarios, important economic trends are developed to a more extreme extent than we consider likely, and we determine the impact of the outcome on the global economy and the financial markets. The use of several scenarios compels us to examine assumptions through a critical lens and enables us to structure portfolios that are robust enough to cope with various macroeconomic outcomes. For all of these scenarios, we prepare forecasts for the expected real economic growth and inflation. These forecasts are at the basis of our vision for the markets.

The basic principle for calculating these expected returns is that in the long run, current valuation criteria tend to produce their expected value. The current interest rate and its expected development is, therefore, the most important factor for expected returns on bonds.

In addition to our assumptions with respect to growth and inflation, we prepare a separate set of assumptions for each asset class. This allows us to determine the expected returns for each asset class in our universe for each scenario. Figure 1 provides an illustration of the yield development of *US high-yield* investments for a ten-year investment horizon.

FIGURE 1: Expected yield development during the investment period for US high-yield corporate bonds in KCM's central macroeconomic scenario



Source: Kempen Capital Management

The expected spread on top of a risk-free loan is a compensation for credit risk, but also for the difference in liquidity and complexity, for instance. Based on our expectations for the yield development and after correction for expected defaults, we arrive at an expected return. The table below describes the expected returns in local currencies for the various high-yield asset classes on 31 August 2019. The chosen foreign currency hedge obviously also impacts the expected returns.

TABLE 1 Return expectations (% a year) in local currencies in the central scenario

× Global high yield	3.6%
× European high yield	2.5%
× US high yield	4.1%
× EMD (hard)	4.7%
× EMD (local)	4.3%
× Structured credit	5.0%
× Direct lending	5.0%
× Leveraged loans EUR	3.5%
× Leveraged loans USD	4.5%

9. High yield within a portfolio

In this document, we have outlined the most important categories in the high-yield spectrum. Table 2 lists the main characteristics of the various categories side by side, based on six criteria that are relevant to investors:

- × The credit risk that the investor runs
- × The extent of direct interest-rate sensitivity of the investment
- × The extent of marketability
- × The market size
- × The complexity of the asset class
- × The cost level

All of these criteria are ranked by a score from 1 to 3; 1 being low and 3 being high.

TABLE 2 Summary of characteristics

	Credit risk	Interest-rate exposure	Liquidity	Market size	Complexity	Costs
HIGH YIELD USD	3	2	3	3	1	1
HIGH YIELD EURO	2	2	3	2	1	1
EMD LOCAL	1	3	3	3	1	1
EMD HARD	2	3	3	2	1	1
LEVERAGED LOAN EURO	2	1	2	2	2	2
STRUCTURED CREDIT USD	2	1	2	3	3	2
DIRECT LENDING EURO	2	1	1	1	2	3

The diversity within the high-yield spectrum entails opportunities for diversification benefits if we combine several of these categories within a single portfolio. This is shown in Table 3, which represents the correlation between the various categories as well as the correlation with commonly used categories such as global shares and euro government loans.

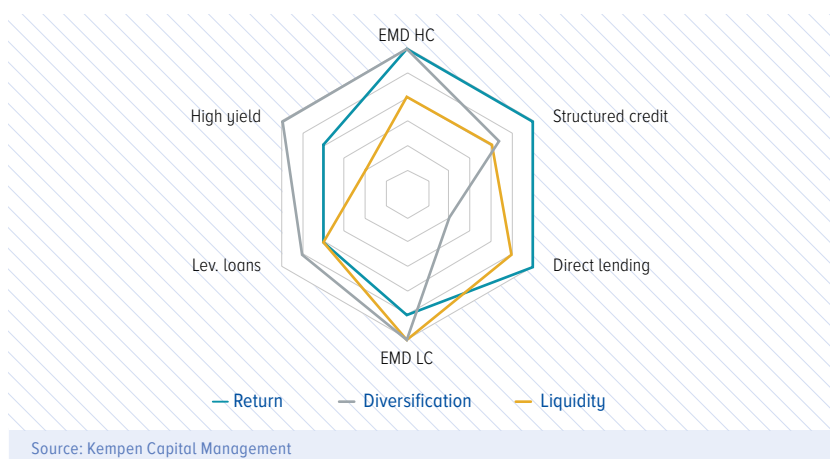
TABLE 3 Correlation table

	1	2	3	4	5	6	7	8	9
1 Global shares	1.00								
2 Government bonds EMU	-0.04	1.00							
3 EUR high yield	0.69	0.11	1.00						
4 US high yield	0.75	0.03	0.89	1.00					
5 EMD (hard currency)	0.52	0.31	0.65	0.72	1.00				
6 EMD (local currency)	0.29	0.41	0.37	0.44	0.78	1.00			
7 Leveraged loans (Europe)	0.55	-0.08	0.87	0.78	0.42	0.16	1.00		
8 Leveraged loans (US)	0.64	-0.10	0.83	0.88	0.47	0.20	0.89	1.00	
9 Structured credit	0.30	0.23	0.69	0.65	0.57	0.45	0.68	0.62	1.00

In general, the correlation between high-yield categories and traditional categories of equities and government bonds is low. Adding high-yield categories to a portfolio may, therefore, add value. Then again, in many cases there is also a low or even negative (green) correlation among the high-yield categories themselves. This means that it may be profitable to include several categories from the high-yield spectrum in an investment portfolio.

The selection of each particular category will depend on the preferences and/or the restrictions of the investor. This revolves around the desired risk-return profile of the portfolio, the desired liquidity, and the envisaged level of sustainability. Figure 2 provides a general impression of how the categories are related in the area of return, diversification benefits within a broader portfolio, and liquidity. Depending on the profile of the investor and the composition of the portfolio, the right high-yield categories can be selected to match the overall picture.

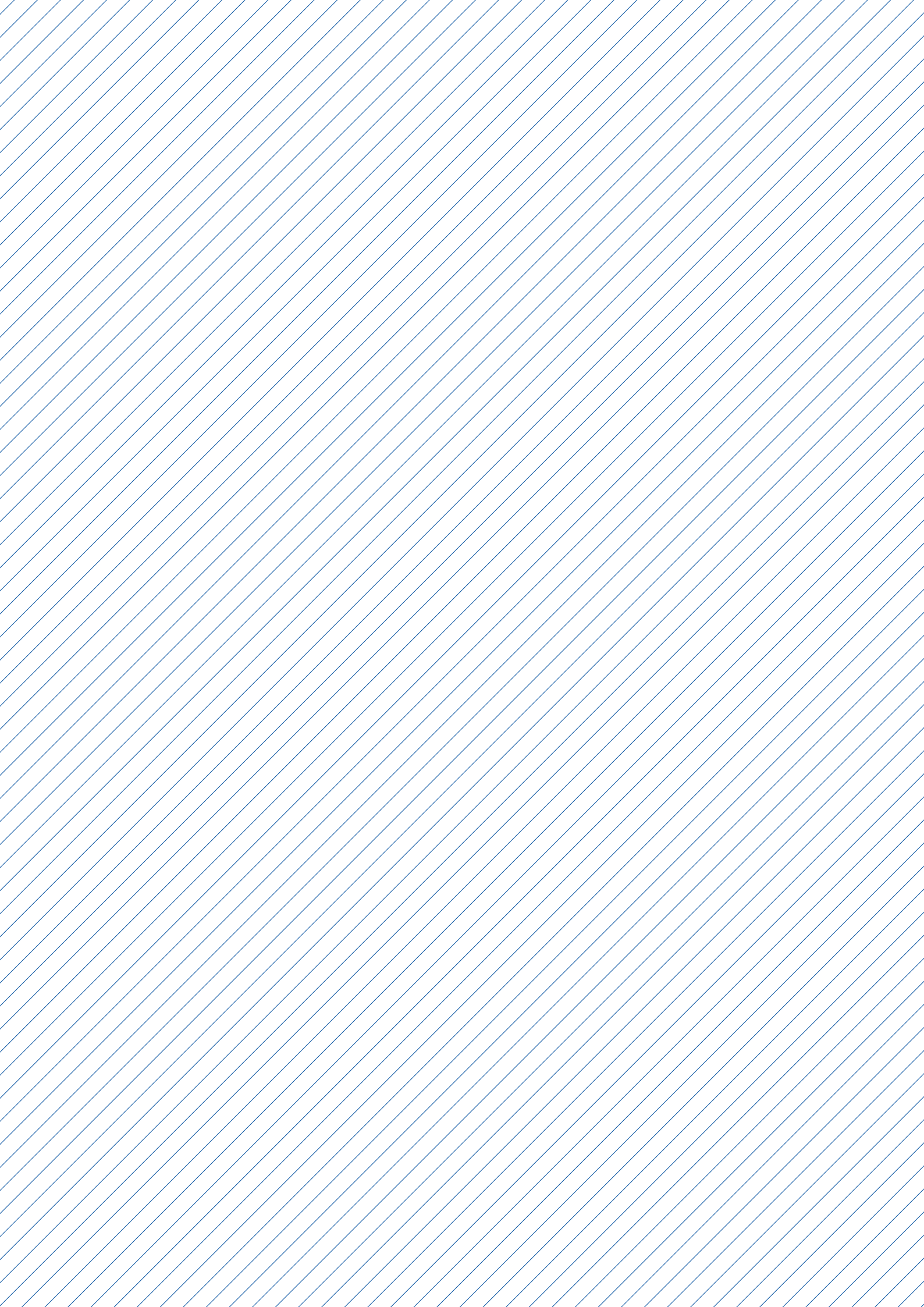
FIGURE 2 Scores of asset classes on return, diversification benefits, and liquidity



Conclusion

We are of the opinion that high-yield categories are a very valuable addition to investment portfolios. The banks' retreat has offered investors an enormous gamut of investment opportunities that may yield attractive returns. In addition, the categories provide an opportunity to increase the diversification within a portfolio considerably, resulting in more stable operating results.

The high-yield spectrum is of a diverse nature and will continue to develop over the next few years. This will offer investors options and opportunities.



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